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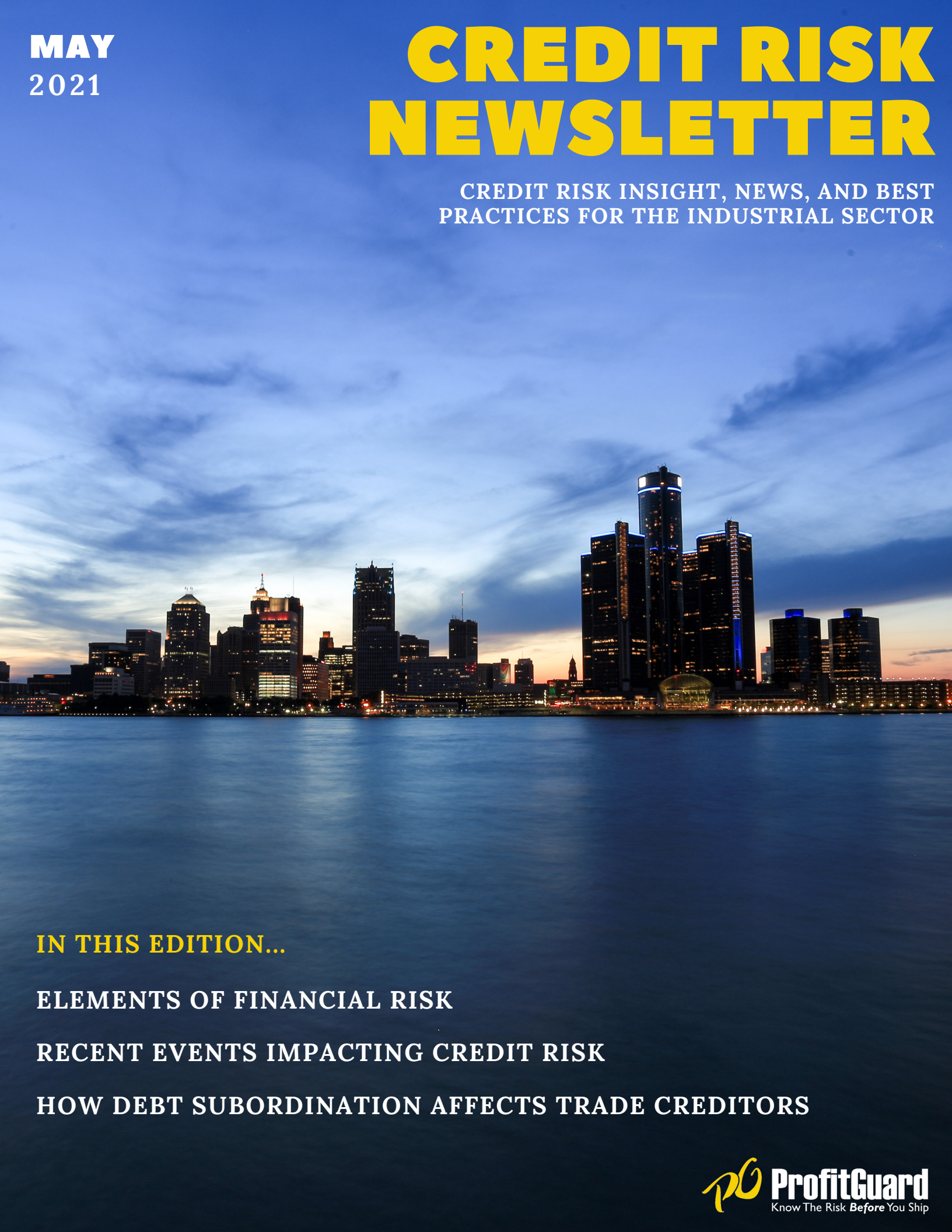
CREDIT RISK NEWSLETTER

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



IN THIS EDITION...

ProfitGuard
Know The Risk *Before* You Ship

ELEMENTS OF FINANCIAL RISK

Financial risk analysis is critical to the credit decision process. Credit professionals should understand the major categories that encompass this type of risk to obtain a better view of the company's overall health. Financial risk typically falls into three categories: profitability, capital structure, and cash flow.

Financial statements and related footnotes, when available, provide valuable insight into a company's operating performance and financial condition. When viewing a company's financial statements, the income statement reports the revenues and expenses that a company generates over a particular period. This provides an indication of a company's profitability. Does the company report a positive or negative revenue trend? Is the company's EBITDA (earnings before interest, taxes, depreciation, and amortization) growing or declining? How thin is the company's profit margin? Is the company reporting consistent income or losses? These are all items that need to be reviewed. Most commodities companies can expect to report wide variations in operating profitability during each business cycle, as there is limited visibility in forecasting prices and supply-demand fundamentals (both drive profitability).

Another key aspect of financial risk is a company's capital structure. Capital structure displays a company's leverage and debt capacity. It shows the company's use, and reliance on, external funding to run its business. Credit professionals will need to reference the company's income statement and balance sheet to understand its capital structure. In most cases, the greater the use of debt, the higher the risk for all creditors. As a rule, a highly leveraged company will report a total debt to EBITDA ratio above 4x. Debt to EBITDA above 4x generally is considered high risk and indicates the company may have trouble meeting its debt obligations. Companies that report a high debt to EBITDA ratio are typically more sensitive to economic deterioration and are at a higher risk for defaults.

Lastly, the cash flow statement helps credit professionals understand how money is flowing in and out of the company. This statement is broken out into three activities: cash flow from operating activities, cash flow from investing activities, and cash flow from financing activities. Analysis of cash flow patterns can reveal the true financial health of the company that might otherwise go unnoticed. Ideally, positive cash flow indicates that the company is managing its operations and growth from its own cash generation. It takes money to make money. Conversely, a negative cash flow might mean a warning sign that a company is mismanaging its asset purchases and growth. Either way, it is important to analyze a company's cash flow over a period, not just a single snapshot, to get a true sense of how the company is utilizing its cash.

RECENT EVENTS IMPACTING CREDIT RISK

M&A Activity

Merger and Acquisition (M&A) activity started to recover in the second half of 2020 and continues to ramp up in 2021. According to the most recent Refinitiv report, global Q1 2021 M&A activity totaled $1.3 trillion, representing a 94% increase over Q1 2020. Some noteworthy deals include:

- On May 6, 2021, Franz Haniel announced it has agreed to sell ELG Haniel GmbH to Aperam S.A. ELG will be acquired as a complete group and continue to operate as a fully separate company. The transaction has an estimated enterprise value of EUR 357 million and is subject to customary regulatory approvals. The deal is expected to close in the second half of 2021. Aperam is a global producer of stainless, electrical, and specialty steel headquartered in Luxembourg.

- PPC Flexible Packaging, a provider of custom flexible packaging, announced the acquisition of Target Labels and Packaging on May 3, 2021. Target is the seventh acquisition of specialty and differentiated flexible packaging firms by PPC in the past four years. The terms of the deal were not disclosed.

- Rayonier Advanced Materials has agreed to sell all of its lumber and newsprint facilities to GreenFirst Forest Products, a Canadian lumber company. The expected purchase price is $214 million and the agreement will likely close in the second half of 2021.

- On April 28, 2021, a consortium led by private equity firm Bain Capital announced it will acquire Hitachi Metals for approximately $7.5 billion. The company expects the deal to close by the end of November 2021 and Hitachi Metals will delist from the Tokyo Stock Exchange.

- Grand Haven-based Molding Solutions Inc. acquired Seabrook Plastics, a molder of plastic parts primarily for the automotive and defense industries. Seabrook Plastics worked with Hudsonville-based mergers and acquisitions firm NuVescor Group to complete the sale. The terms of the deal were not disclosed.

Manufacturing Outlook

U.S. manufacturers reported an upswing in activity in April despite supply chain issues. Chris Williamson, chief business economist at IHS Market reported "The U.S. economy is enjoying a strong start to the second quarter, firing on all cylinders as loosening virus restrictions, an impressive vaccine rollout, a brighter outlook and stimulus measures all helped boost demand." However, the increased demand is weighing on the supply chain, which could curtail growth somewhat. Demand continues to outpace supply in most areas including plastics, metals, and electronic components, which impacts a range of industries including automotive, computers and electronics equipment, and others.

Harbour Results, a manufacturing industry consulting and benchmarking company from Southfield, Michigan, reported its Q1 Manufacturing Pulse Study recently. It indicated that sentiment is up, capital spending is planned, and utilization has increased. Most manufacturers across all processes are planning for capital investment of 3% or more from 2021-2023. IHS Market also reported that worldwide orders for business equipment rose at the fastest rate for a decade in April, as increasing numbers of companies invested in expanding their businesses. IHS's April survey showed new orders for investment goods such as machinery and equipment rising at the sharpest rate since April 2010.

Steel Price Bubble?

Steel market conditions continue to improve, which is benefitting major steel companies like United States Steel, Nucor, and Steel Dynamics. These companies have enjoyed improved credit metrics and stock rallies. U.S. Steel and Big River Steel were upgraded last month by both S&P Global Ratings and Moodys because of the positive outlook and elevated steel prices. Cleveland-Cliffs was also upgraded in April because of the "materially improved steel sector fundamentals."

However, because of the massive steel shortage created by the pandemic, some analysts are warning of a steel price bubble that could burst soon. Steel prices crashed during the initial shock of the pandemic in 2020. Fast forward a year later and prices for flat rolled steel products are at all-time highs. For reference, these steel prices bottomed out around $400-500 per ton back in April and May 2020. According to Steel Market Update, part of the CRU Group, most steel buyers are telling us that the market remains very tight. This points to further price increases near term. Hot rolled coil is now averaging $1,500 per ton and cold rolled coil is around $1,700. But, the market is bound to correct and when it does, it usually overcorrects, which could send prices tumbling.

High Freight Rates

Elevated shipping costs continue to be a headache for companies across all sectors. As Bloomberg reports, the higher shipping costs have been sparked by a combination of factors, including soaring demand amid stimulus checks, saturated ports, and too few ships, dockworkers, and truckers. The problems are too broad to be remedied by any short-term fix and are creating ripple effects across U.S. supply chains.

According to Freightos, Asia to both U.S. East and West coasts are still experiencing very high volumes and port congestion, pushing factory-to-door delivery times to an average of nine weeks compared to four to five. High consumer demand and still lagging inventory levels suggest no let up is coming anytime soon, with additional demand expected from ocean freight's annual peak season in July not far off. With expensive and volatile ocean freight, some companies are turning to air freight. Air cargo shippers are dealing with rising fuel costs that are keeping these rates elevated. With the increased ocean, air, and trucking rates, many companies are being forced to pass along the increase to consumers.

HOW DEBT SUBORDINATION AFFECTS TRADE CREDITORS

Most businesses rely on a mix of debt and equity to operate. When a company takes on several debt instruments, this impacts who gets repaid should that company default on the debt agreement, file for bankruptcy, or go out of business. In most cases, the more debt, the less likely any assets will be left to pay general unsecured claims, which typically include trade creditors. Unsecured trade creditors are usually last in line to get paid. Below we will discuss the key aspects of debt subordination and how these play into a company's overall risk profile. Credit managers need to determine and understand the seniority of the company's debt.

Senior debt has the highest priority claim. This debt is normally secured and backed by the company's collateral (property or other assets). Secured debt will usually have lower interest rates and more favorable maturity because if the borrower defaults on the secured debt, the lender has the right to foreclose on and sell the pledged assets, using the proceeds to satisfy the debt. Subordinated, or junior debt gets repaid only after all senior debt is repaid.

According to S&P Global Ratings data, debt instruments that are more senior tend to exhibit higher recoveries with lower variance than more junior debt. S&P defines recoveries as the ultimate recovery rates following emergence from three types of default: bankruptcy filings, distressed exchanges, and non-bankruptcy restructurings.

Historically, revolvers show the highest recoveries, with an average recovery of 79.3%. Recoveries fall considerably for second-lien (and unsecured) term loans, with an average recovery 44%. As subordinated debt typically accounts for a small share of the firm's debt structure, there is often no value left to provide recoveries for these instruments in bankruptcy after the senior debt holders are paid. In 2020, recoveries

of term loans and revolving credit facilities that emerged from default averaged 64.2%, in line with the average of recent years, yet below the long-term average of 74%. Rising leverage, shrinking debt cushions, and the prevalence of covenant-lite instruments have weighed on recent loan recoveries, and are expected to continue to challenge loan recoveries.

Once senior and junior debtholders are repaid, there are typically no assets left to pay unsecured trade creditors. Therefore, it is crucial to understand your customers debt structure and where you fall in the repayment schedule.