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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

RECENT EVENTS IMPACTING CREDIT RISK

Bankruptcy Trends

According to S&P Global Market Intelligence, a total of 574 companies have gone bankrupt this year as of November 15, still on track to surpass the figure from 2019. The top three sectors leading the bankruptcy filings are consumer discretionary, industrials, and energy. Market Intelligence's analysis is limited to public companies or private companies with public debt where either assets or liabilities at the time of the bankruptcy filing are at least $2 million. Private companies without public debt must report at least $10 million in either assets or liabilities at the time of filing.

ProfitGuard has tracked over 27 bankruptcies in the metals and plastics sectors through 2020 so far. We expect this trend to continue unless COVID-19 risks fade substantially.

Elevated Liquidity

With credit markets awash with more liquidity than ever, this could spell trouble as we face a prolonged recession. With central banks throwing all available monetary tools to use, this essentially resulted in higher debt leverage and looser loan terms for many companies. With weak economic recovery prospects, these companies will likely face double trouble with weaker operating results and higher debt service payments, resulting in a higher risk of financial difficulties.

Private Equity Payment in Kind (PIK) Trends

Private equity firms are increasingly using payment in kind loans to deal with financially distressed borrowers. Also known as a PIK loan, this is a loan instrument whereby the interest is added to the principal balance of the loan instead of being paid to the lender in cash. Essentially, a PIK loan gives the company the ability to defer interest payments to the lender until the loan's maturity date. A payment in kind note is typically given to higher-risk entities. Interest rates are normally high; we have seen PIK loans with interest rates above 15%. While it may seem like a positive that a company does not have to make monthly interest payments, the principal balance of the loan can quickly climb to unsustainable levels and cause problems when maturity rolls around.

Trucking Challenges in the Scrap Industry

The scrap industry continues to deal with difficult transportation obstacles and costs. According to American Trucking Associations, capacity is tight and for-hire fleets are operating fewer trucks than a year ago. According to DAT Solutions, shippers and carriers increasingly are leaning on short-term freight contract agreements vs. longer-term. With an imbalance in certain sectors, this has led to an influx of freight to the spot market, causing rates there to surge in recent months. Contract rates, meanwhile, have been more stable. With shippers, carriers and brokers all trying to manage the ongoing uncertainty and fluctuations in the market, shorter-term contracts allow parties to make agreements and adjust those freight agreements as the market changes.

DELAYED DRAW TERM LOANS

Lenders continue to adapt to the ever changing and uncertain economic environment. One recent adaption has been the lender crackdown on offering Delayed Draw Term Loans (DDTLs) and how proceeds from these loans are used.

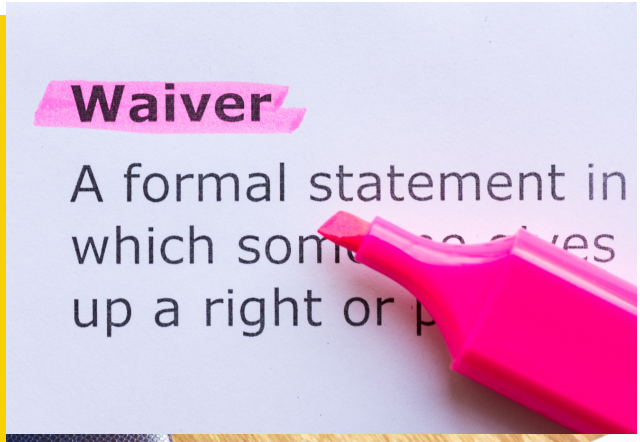
A DDTL differs from traditional term loans in that borrowers draw on the funds at a future date rather than receive all at the closing of the transaction. Lenders find DDTLs attractive because they collect fees even when the facility is not being used. Borrowers find these appealing because they provide easily accessible financing for acquisitions, and up until recently, general corporate purposes.

Prior to the pandemic, DDTLs were readily available and provisions governing how funds were used were lax. Borrowers could simply cite the need for investment or general corporate purposes. This allowed borrowers to use DDTL borrowings for things other than their original intention, which lenders intended them to be acquisition focused.

At the onset of the pandemic, borrowers rushed to drawdown their DDTLs to bolster their balance sheet and liquidity. Lenders had to honor these borrowings or risk causing defaults and damaging their reputation. This came while lenders own financial stability was in question. In response to the flurry of drawdowns, lenders have since heavily scrutinized DDTLs and how borrowings are used. Some lenders have stopped offering DDTLs altogether.

Many lenders have returned to providing DDTLs but the provisions and covenants governing them and how they can be used are now a lot more restrictive. This comes while lenders are also cracking down on how borrowers use proceeds from revolving credit facilities, with a focus on them being for working capital needs and not acquisitions. Overall, lenders continue to shift toward more conservative and restrictive policies as the pandemic reshapes the credit markets.

LENDER REMEDIES FOR DEFAULTS; WAIVER VS. FORBEARANCE AGREEMENT



With an uptick in borrower defaults, we thought it would be prudent to discuss remedies lenders can use to provide relief to the borrower.

Companies that take on debt in the form of loan or credit agreements are usually subject to loan covenants set by the lender. A loan covenant is a condition that the borrower must comply with to adhere to the terms in the loan agreement. Loan covenants aim to protect investors and lenders and can act as an early warning sign of deteriorating performance. However, if the borrower violates any of its covenants, the lender can demand repayment in full.

In most cases, lenders will work with borrowers to provide some sort of resolution. As stated by Texas Lawyer, waiver and forbearance agreements contain many similar provisions, and they both provide a certain amount of relief for the borrower. One significant legal difference: A forbearance agreement will not eliminate the default. To the contrary, in a forbearance agreement the lender will temporarily agree not exercise its legal rights and remedies against the borrower, solely if the borrower complies with the terms of the forbearance agreement. A waiver agreement, on the other hand, waives the default and restores the parties to their pre-default positions.

From a credit perspective, if your customer reports a covenant violation, this should raise concern. They would not need a waiver or forbearance agreement if they were in sound financial health. However, a waiver is more favorable; it allows the borrower to maintain the loan for an extended time to take the necessary steps to become compliant for future periods. Plante Moran explains that in a forbearance agreement, this could restrict new borrowings, CapEx, and owner distributions. It could also require more collateral or the lender could initiate foreclosure/liquidation proceedings.

If your customer has breached loan covenants, you will want to speak with company management and the

lender to obtain additional details. Did the lender provide a waiver or forbearance agreement? If a waiver was provided, how long is it for? Does it also include amendments to any covenants? If a forbearance agreement was provided, what are the terms and how long is it for? These are all questions that need to be answered.

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