OCTOBER
2020

CREDIT RISK NEWSLETTER

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

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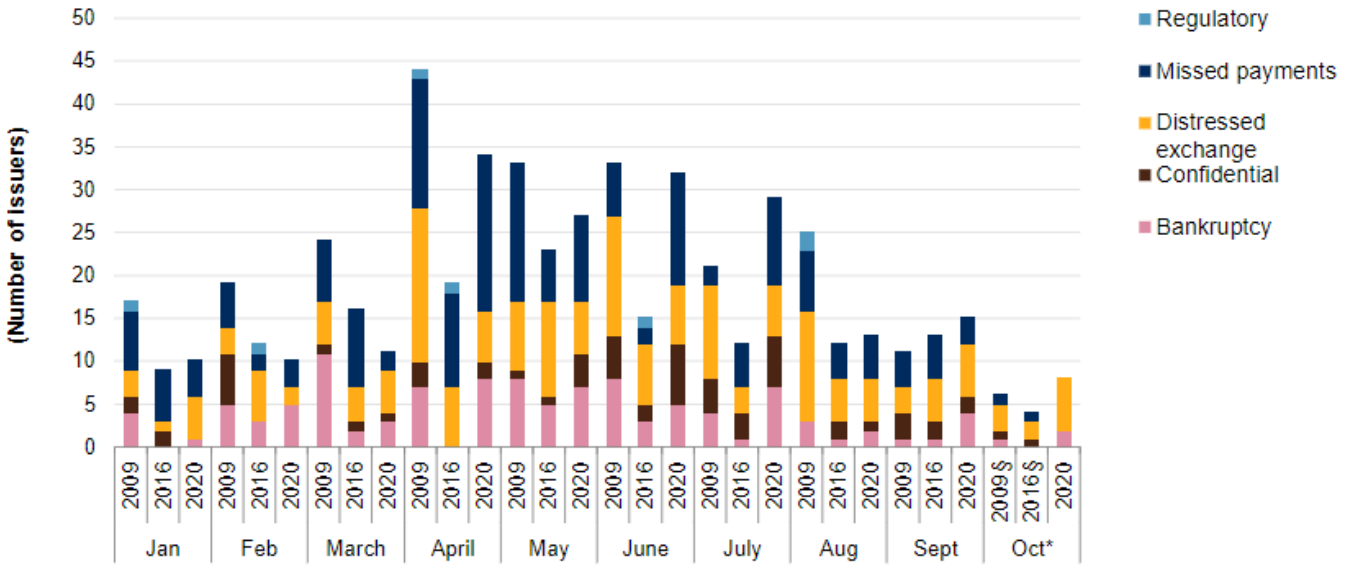
DISTRESSED DEBT EXCHANGES ON THE RISE

With an uptick in distressed debt exchanges (DE), we thought it would be best to explain what they are, why companies use them, and how they impact credit risk.

In a distressed debt exchange, a troubled company offers creditors new or restructured debt, or a new package of securities that amounts to a diminished financial obligation relative to the original obligation. Essentially, existing debt holders take a haircut on their principal amount. Consistent with our rating criteria, this constitutes as a default because creditors receive less par value than the original terms promised. Unless the DE significantly improves the distressed company's capital structure and liquidity position, credit professionals should view this as a warning sign.

Global monthly corporate defaults in 2009 YTD, 2016 YTD, and 2020 by reason



Distressed exchanges lead the corporate default tally in the second half of 2020 so far as more companies turn to them to avoid bankruptcy. The pandemic-induced stress has prompted several companies to pursue this option. A few factors have made these out-of-court restructurings more attractive than traditional bankruptcy. According to Moody's, these factors include the growing share of private equity sponsors that own highly leveraged companies, the growth of the distressed debt asset class, and deterioration in corporate debt covenants. Most of the DEs have been in the retail, consumer products, and oil & gas segments.

Fitch Ratings states that although DEs result in a material reduction in terms for the affected creditors, often creditors are willing to accept the terms of a DE for a few key reasons. First, distressed debt exchanges can

sidestep the need for bankruptcy, which can be a lengthy and value stripping process. In fact, many creditors will accept a DE as they may fare worse in a bankruptcy. Secondly, DE negotiations are typically limited to a specific set of creditors, which can make a transaction easier to execute. Lastly, some creditors convert their debt to equity and become owners, which will allow them to realize a return later if the company is sold.

DEs can result in maturity extensions for near-term debts, deferral of principal or interest payments, or amendments to payment terms that either converted interest payments from cash to payment-in-kind, reduced coupon rates or both. While this is usually the best recovery for debt holders, it will not always help suppliers get paid in the event of default. Suppliers still remain the lowest on the creditor pecking order.

COMMODITY FORECASTS

The outlook is starting to look up for a variety of sectors after months of headwinds. The COVID-19 pandemic led to shutdowns around the world, slowing global growth, and supply chain disruptions. Many sectors are starting to recover and it is expected that demand will continue to increase in 2021.

Production of aluminum has increased this year while demand has decreased, which has led to a short-term overcapacity issue. According to the National Bureau of Statistics, in the first nine months of this year aluminum production is up 2.8% from the year before. In the third quarter, demand started to improve and is projected to increase in 2021. The Economist Intelligence Unit states that global primary aluminum demand for the year will decline by 6.8% and then rise 4% next year. Aluminum prices have started to see a recovery since reaching four-year lows in March due to the COVID-19 pandemic. Continued strength in China and improving industrial demand should support higher aluminum prices in the near term.

Another metal closely tied to China is copper, which has also started to surge lately. Copper prices and demand have started to rebound after the Chinese economic shutdown earlier this year. Prices have recovered roughly 40% since March. Demand for

copper is expected to rise by 2.3% in 2021 according to the Economic Intelligence Unit.

The steel sector has been significantly impacted by the pandemic this year. Output of steel in the U.S. is down 19.3% year-to-date but is slowly recovering. The capacity utilization rate and price of steel continue to rise. Increasing demand in the automotive industry has helped demand for steel. However, the construction industry faces a slow recovery from the economic downturn. The Economic Intelligence Unit expects 4.6% growth in steel demand next year.

Before the pandemic, the U.S.-China trade war affected the price of plastics worldwide. Due to the economic downturn, the plastics industry has also been negatively impacted by weaker demand in many industries, including the automotive, construction, and oil industries. The outlook for the plastics industry is uncertain. The trade war, environmental laws regarding plastic use, and the extent of the economic downturn will all play roles in how the industry will proceed in the future.

Unlike most other sectors, many electronics companies have experienced a surge in demand from the COVID-19 pandemic. This is primarily due to an increase in people working from home and online learning. It is expected that the electronics industry will continue to grow in the near term.

OIL & GAS SNAPSHOT: DEFAULTS REMAIN HIGH

The pandemic upended the global oil market, pushing WTI crude oil prices into the negative for the first time in history. As a result of plunging prices and demand, it should come to no surprise that the oil & gas sector leads the overall corporate default tally so far in 2020.

Haynes and Boone's Oil Patch Monitor reports the number of North American oil & gas producer bankruptcies. In the third quarter of 2020, 17 producers filed for bankruptcy, which, combined with the rest of the filings earlier this year, represents a 21% increase year over year. Without a meaningful recovery in oil prices expected, oil & gas defaults will likely continue. The U.S. Energy Information Administration anticipates WTI crude to average $38 per barrel in 2020, rising to $44 per barrel in 2021. Brent crude is expected to average $42 per barrel in the fourth quarter of 2020 and will rise to $47 in 2021. In most cases, for companies to produce oil profitably, Brent needs to be over $50 per barrel and $40 per barrel WTI.

"We expect the number of oil & gas defaults will continue to climb, given the sector's negative bias remains elevated, especially for the most vulnerable issuers," said Sudeep Kesh, head of S&P Global Credit Markets Research. Negative bias is defined as the proportion of issuers rated by S&P Global Ratings with negative outlooks or ratings on CreditWatch with negative implications.

Another factor contributing to the defaults is the rise in secured debt held by lenders in the oil & gas industry. These lenders are facing significant losses, leading to restructurings and asset sales. According to Haynes and Boone, the North American oil & gas producers that have gone bankrupt through the first eight months of 2020 carried approximately $24.4 billion in secured debt, which is above the $20.3 billion secured debt held by the 70 drillers that went bankrupt in all of 2016.

Energy defaults and restructurings are bound to continue. Customers and their supply chain should be monitored closely given the heightened default risk.