ProfitGuard | Sept. 2019

Credit Outlook: Metals & Manufacturing Sector

Areas of Concern

- Recession Risk
- Trade Uncertainty
- Slowing Growth
- Steel Capacity

Recession Risk

As of July 2019, the current business cycle which began in June of 2009, reached a historic record as the longest U.S. economic expansion on record as it hit 121 months. As a refresher, a typical business cycle has four parts, expansion, peak, contraction, and trough. Once we hit the trough, we are basically in a recession or two consecutive quarters of negative GDP growth.

Based on key financial market indicators leading up to July, we are seeing increasing risk of a recession in the coming 12 months. According to S&P, the probability sits at 35%. One of the key drivers contributing to increased risk of global growth is trade uncertainty. The U.S.-China tariff dispute is beginning to negatively impact all businesses whether its due to added costs they need to absorb, uncertainty on planning for investment, or higher prices to consumers which could slow demand.

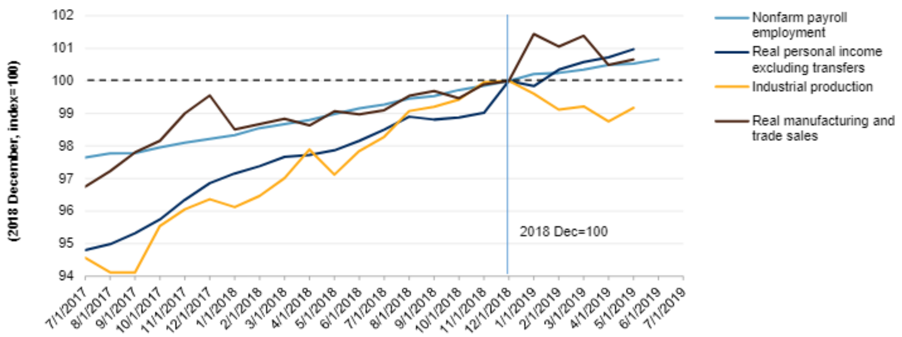
The Institute for Supply Management Report (ISM), which measures manufacturing activity, contracted for the first time in three years as reported in early September. Residential investment has been contracting since the beginning of 2018 and employment in the housing sector has fallen since March of 2018. Other cracks on the surface include slowing freight transportation, slowing auto sales, and signs that residential investment is weakening.

Experts at the Economist warn that most recessions follow a cycle of tightening monetary policy, during which the Fed raises rates in order to prevent inflation. In the current scenario, the Fed has maintained favorable monetary policy with low rates for a long time, so there may not be much to cut, should a recession hit.

The first rumblings of downturns usually appear in areas in which growth depends heavily on the availability of affordable credit. Housing is often among the first sectors to wobble; as rates on mortgages go up, this chokes off new housing demand.

In addition to housing, you must watch manufacturing activity, as it too tends to falter before other parts of the economy. Often manufacturing growth peaks many months before an actual recession. Both key indicators showing weakness are lending strength to rising recession risk. Despite these factors, consumer spending has been strong, and the Fed has since reversed its course and will likely lower rates. These actions could help delay a broad slowdown.

Industrial Production Has Slowed Down In The First Half Of 2019; Will It Spill Over To The Rest Of The Economy In The Second Half?



Source: BLS, Federal Reserve, BEA via St.Louis FRED, S&P Global Economics calculations.

Payment Trends

According to Atradius' June 2019 payment barometer survey, the value of overdue invoices is highest in the metals sector at 40.4% of the total value of B2B invoices. The ICT/electronics sector at 33% and the construction sector at 32% follow. The transport sector recorded a low of 11%.

Overall the survey indicates that a significant percentage of B2B invoices are overdue 24.3%, in relation to total credit sales which is 55.2% of total B2B account receivables, see figure 2. Small and medium sized companies recorded the highest rate of uncollectable receivables (2%), compared to 1.3% for large and micro enterprises, 1%.

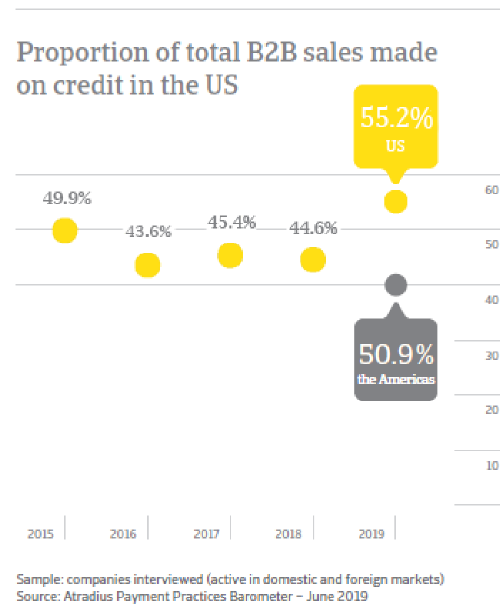
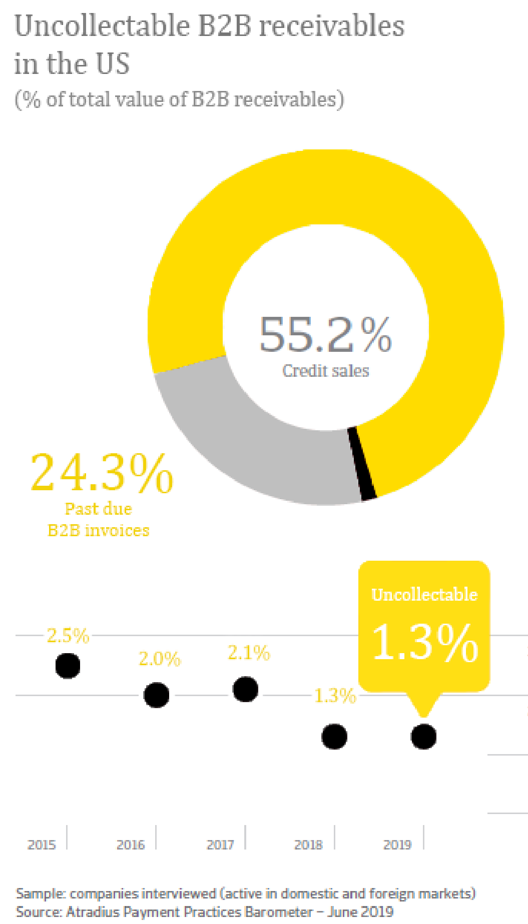


Figure 1

Atradius also stated that despite being far more likely to sell on credit to B2B customers than one year ago, respondents in the U.S. do not appear similarly inclined to set more relaxed payment terms. Most U.S. survey respondents (89%) requested quicker payment of invoices from B2B customers than one year ago, with terms averaging 24 days (down from 27 days last year). These are the shortest in the USMCA region and compare to an average of 37 days in Canada (up from 25 days last year) and 27 days in Mexico (down from 33 days one year ago). In Brazil, the average is 38 days (up from 32 days last year).

Figure 2



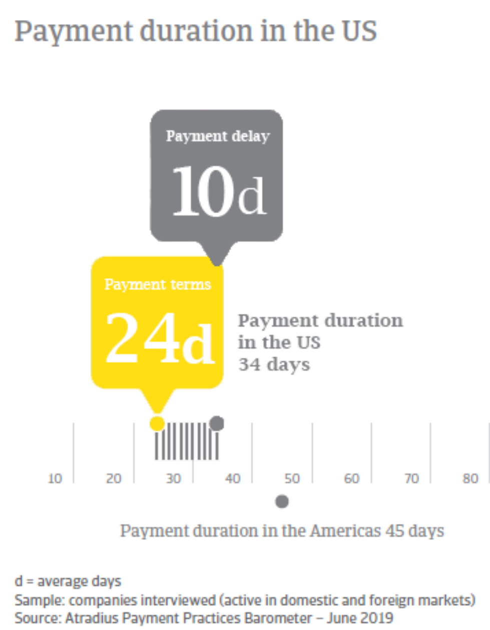


Figure 3

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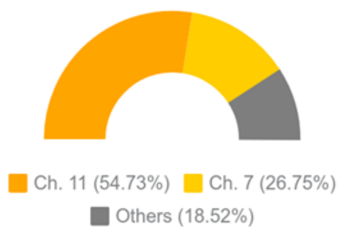
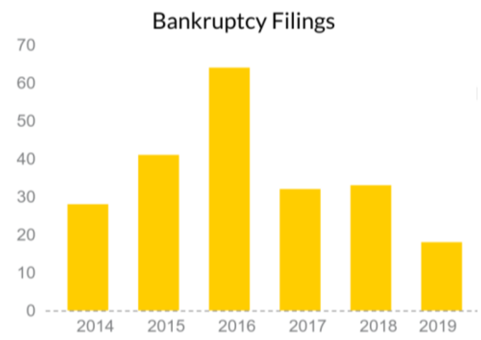
Major Bankruptcies and Insolvencies since 2014



2014-2019 Total Filing Breakdown

Bankruptcy Stats

Over the past year, business bankruptcies have been at historic lows. However, there have been pockets of insolvencies, with some sectors seeing slight upticks. Overall, we have tracked 19 bankruptcies so far in 2019 and its already September, which indicates a benign bankruptcy environment.



"…we have tracked 19 bankruptcies so far in 2019."

Most of the business bankruptcies occurred in the retail an oil and gas segment to date. You may be thinking, how long can this trend last? We expect insolvencies to rise slightly over the next 12 months, in the range of 1-2% as the softening business environment and fallout from trade tension drags on. Credit availability to business borrowers remains favorable despite record levels of corporate debt and leverage. We believe this will support stability in the near term.

Steel Capacity Conundrum

Since the Trump Administration took office, several trade actions were put in place that gave Steel Makers confidence in investing in their operations and adding capacity. Now all that added capacity could have a significant impact on steel economics, boosting supply and pressuring prices. Moreover, *Bank of America Merrill Lynch Global Research* has stated that all the new capacity can herald a period of weak prices, prompting closures of less efficient capacity, after which prices can normalize.

From a credit risk perspective, a shakeout such as this, could impact suppliers with exposure to the steel plate, sheet, and rebar markets. We recommend proactively managing your credit risk in this segment if you are a supplier.

Source: *Bank of America Merrill Lynch Global Research*

Corporate Credit

Credit risk has increased. Cashflow headwinds continue to pressure credit quality. Considering intensified trade tension, slower growth, weaker global economies, and growing labor and input costs, we expect corporate earnings to experience pressure.

We are also seeing the incidence of small and medium sized businesses paying late, tripping covenants with their banks, and companies showing weaker profitability has continued to increase in 2019. The current credit cycle is mature and will turn soon, we just don't know when.

Complacency has likely settled into your credit process in one way or another. Now is the time to begin reviewing your corporate risk appetite and tolerance to make necessary strategic adjustments for the next cycle. Having a strong credit policy and corresponding protections in place will provide necessary shelter in a potential downturn.

What to watch

Customer Account risk

Working Capital:

- Check bank compliance regularly
- understand the borrowing base
- ask about availability
- watch for inventory accumulation

Macro Items

Fed Rate Actions: Lower rates will ease debt service

Trade War Intensity: Less tension would support confidence

Industrial Production: clue to potential contraction

ProfitGuard is the leading provider of business credit information to the metals industry of North America. PG assists its clients in managing trade credit risk with valuable credit analysis, credit risk ratings, recommended credit limits, and risk monitoring of their customer portfolios. With PG's information service, businesses can make more informed credit decisions, minimize bad debt losses, and more effectively manage credit risk to remain competitive in today's rapidly changing marketplace.