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CREDIT RISK NEWSLETTER

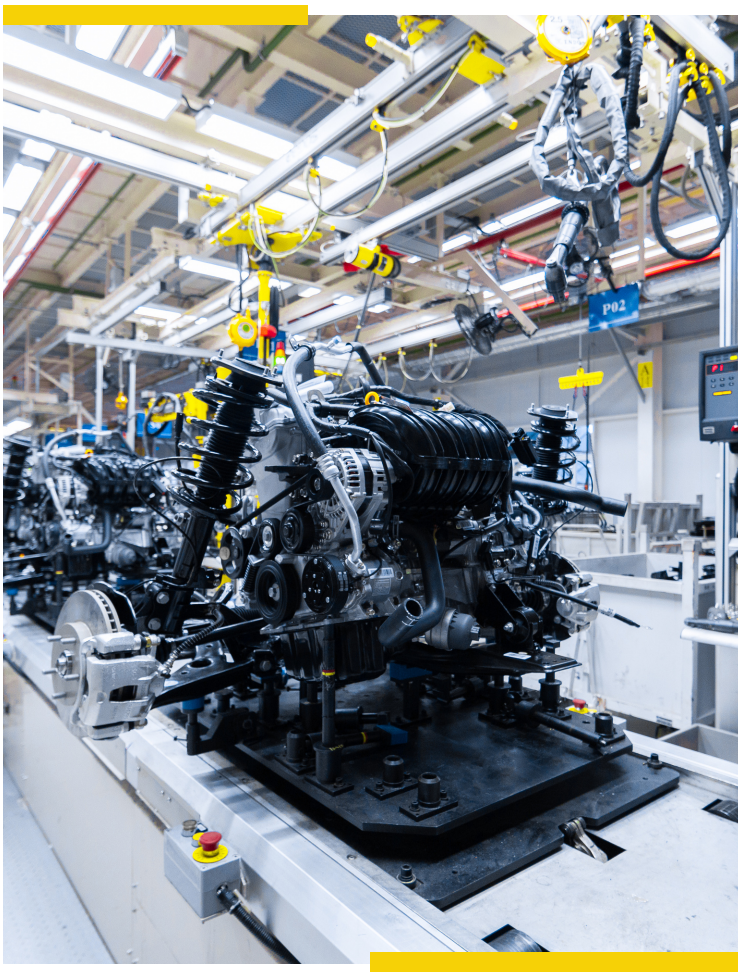
CREDIT RISK INSIGHT, NEWS, AND BEST PRACTICES FOR THE INDUSTRIAL SECTOR

IN THIS EDITION...

ProfitGuard
Know The Risk Before You Ship

AUTOMOTIVE SPOTLIGHT: SLOW RECOVERY AHEAD

The pandemic driven economic downturn adversely affected numerous industries across the globe. The automotive industry was not immune and was one of the hardest hit as manufacturers idled production for two months during the early stages of the outbreak. We are starting to see some stabilization but expect volumes to remain low in the near term.

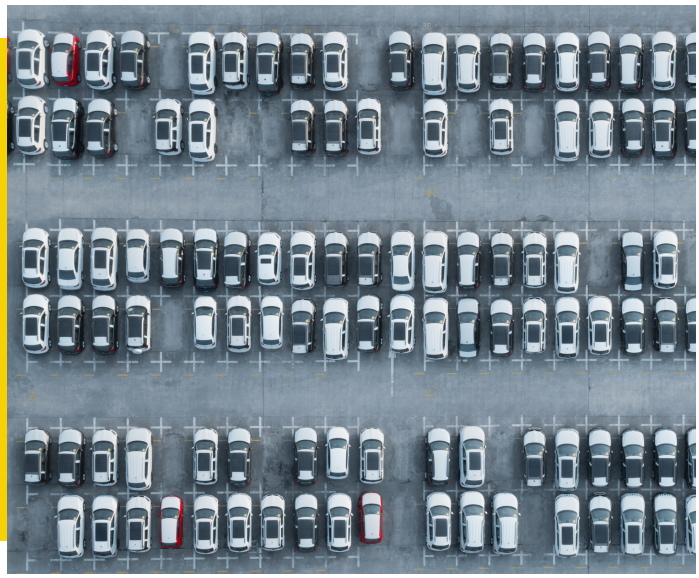


S&P Global Ratings and Moody's Investors Service expect global light vehicle sales to fall 20% this year compared to 2019, following sales and production disruptions in the first half of 2020. It is likely that automakers and suppliers will operate at reduced and less efficient levels for the remainder of the year. There is also an expectation that supply chains will become more localized as manufacturers look to combat trade tensions (tariff pressure and physical restrictions) and risks posed by future pandemics. In addition, Moody's expects automakers will increasingly prefer to maintain a roster of multiple suppliers for individual parts to minimize the physical and economic risks that can arise when relying on a single source provider.

We further note that the pandemic will likely impact consumer demand for cars moving forward. On one hand, consumers may adapt to private transportation instead of using public transportation. On the other hand, more people are working from home and there is generally less business travel activity, which could limit demand for new cars.

In the United States specifically, the supply of new vehicles continues to fall. This means that new vehicle production is not catching up to sales. August was the fourth consecutive month of growth from the April low point of 8.6 million units. Still, the current forecast for full-year light vehicle sales is between 13-15 million units, down from 2019.

Major automotive manufacturers have experienced pressured credit metrics because of the slump in production and disrupted supply chains. Consequently, this has caused several bankruptcies within the automotive supply industry this year including Pace Industries, Shiloh Industries, Garrett Motion, and APC Automotive Technologies to name a few. Even though production is starting to stabilize, many suppliers likely



remain distressed. Because of this, PwC anticipates a significant rise in acquisitions resulting from distressed opportunities in the remainder of 2020 and into 2021.

With political uncertainty in the upcoming presidential election and unease surrounding the pandemic, the automotive industry and its supply chain will need to be monitored closely. However, we note key players in the industry have entered this recession with stronger balance sheets and financial standing than that of the Great Recession in 2009, bringing hope that a rebound will materialize. Now is the time to review credit risk on major automotive manufacturers and their suppliers.

DEMAND LETTER BASICS

Credit managers will likely have to deal with past due situations during their career. No one wants to have these occur on their watch, but when it does happen, having a go-to demand letter can be a game changer. A formal demand letter can increase your chances of payment after your calls and emails have been avoided.

For starters, what is a demand letter? A demand letter is a preliminary tactic used by individuals or companies as an attempt to resolve a dispute, usually over a form of payment owed by one party to another. It is usually the last option before taking formal legal action. In our experience, a clear and concise demand letter can help resolve the issue instead of heading to the courts.

To prepare an effective demand letter, it is important to pull together all pertinent documentation pertaining to your customer and the account at issue. According to NACM Business Credit Magazine, you should have at least the following documents:

- All applicable contract (s)
- All oustanding invoices
- All statements of account
- All pertinent communications with the customer and
- Documentation of any defense or excuses asserted for non-payment

The next step is to draft your demand letter. You will first want to consider who should receive the letter; will you send to the accounting department, a specific account contact, or include higher-ups like the President or Chief Financial Officer? Sending to multiple contacts might help draw more attention. The letter should clearly and correctly demand the amount owed. You may also want to attach the necessary invoices to back up your claim. Additionally, you will want to provide a deadline for payment to be made. Without a hard deadline, the letter may be discarded or not taken seriously. Lastly, provide an ultimatum if your demand is not met. This usually involves stating your company will consider all available legal options if payment is not met within the referenced timeframe.

Every time you ship material to a customer on open credit, this risk of incurring a bad debt occurs. If you need to send a demand letter, you could lean on your legal counsel. If you do not have access to an attorney or legal counsel, receiving help from a credible credit management firm like ProfitGuard is another option. Having a demand letter template in your back pocket is a valuable resource and should be part of your credit toolkit.

FED KEEPING RATES LOW FOR THE FORESEEABLE FUTURE

In its most recent policy meeting, the Federal Reserve signaled it expected to hold rates near zero for at least three more years. The central banking system continues to work to alleviate the economic fallout. Since mid-March, the Federal Reserve has kept interest rates low, increased asset holdings, and set up 13 emergency lending facilities, unlocking more than $1.0 trillion of funding. With near zero interest rates for the foreseeable future, what impact will this have on corporate credit and access to capital?

In general, the banking industry maintained strong capital and liquidity levels at the end of the second quarter, as indicated by FDIC's Quarterly banking profile. The Fed's most recent bank stress test also showed the strength of large banks under many different scenarios. The evidence suggests that most creditworthy small and medium-sized businesses can currently get loans from private-sector financial institutions. Smaller banks, however, may have a more difficult time and could fail. Fed Chairman Jerome Powell stated "I do think that smaller banks are going to probably bear too much burden here… so I think we'll be watching carefully to make regulatory adjustments to make sure that we give those banks every chance to serve their customers and to make it through this difficult time."

Many borrowers will benefit from the Fed programs, as will the overall economy, but for others, a loan that could be difficult to repay might not be the answer. The Main Street Lending Program (Main Street) is intended for businesses that were on a sound footing pre-pandemic and that have good longer-term prospects. Main Street loans might not be the best fit for some as these loans cannot be forgiven like PPP loans. In these cases, direct fiscal support may be needed. Chairman Powell expressed these concerns to the U.S. Congress recently, stating the economic recovery could suffer if lawmakers fail to pass new stimulus. "The recovery will go faster if we have both tools (fiscal and monetary) continuing to work together." This is especially true for small businesses and low-income households. Most economists and policy analysts expected the Senate and the House to agree on new fiscal stimulus, but those prospects are still up in the air. Renewed talks show some signs of progress but there is no guarantee a new bill will pass before the upcoming election.

The U.S. economy has shown improvements since the lockdown in the second quarter. However, the Fed expects near zero interest rates until a full recovery is well under way. The recovery could face headwinds if fiscal stimulus is not passed, if there is social unrest because of the presidential election results, or if there are problems with the COVID-19 vaccine.

COMMERCIAL AND INDUSTRIAL LOAN PAST DUES RISE

The Federal Deposit Insurance Corporation (FDIC) recently published its second quarter 2020 results. The FDIC Quarterly provides a comprehensive summary of the most current financial results for the banking industry. It provides timely analysis of economic and banking trends at the national and regional level that may affect the risk exposure of FDIC-insured institutions and research on issues affecting the banking system and the development of regulatory policy. As a result of the economic stress, banking income saw significant declines and commercial and industrial (C&I) loan past dues increased.

C&I past dues increased 15.5 percent from the previous quarter. Past dues are considered 90 days or more past due. Commercial and industrial loans include loans for commercial and industrial purposes to sole proprietorships, partnerships, corporations, and other business enterprises, whether secured (other than by real estate) or unsecured, single-payment, or installment. When businesses stop making payments on their loans, it can cause banks to become distressed and potentially fail. This will be something to keep an eye on if C&I loan past dues continue to rise.