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WHAT YOU DON'T KNOW…

EXTENDING CREDIT TO CUSTOMERS HAS BECOME RISKY BUSINESS IN TODAY'S SCRAP MARKETS—AND NOT JUST WHEN EXPORTING. CREDIT REPORTING SERVICES, CREDIT INSURANCE, AND OTHER RISK-MANAGEMENT TOOLS CAN HELP MITIGATE POTENTIAL LOSSES.

BY JASON DWORIN

In 2002, then-U.S. Secretary of Defense Donald Rumsfeld memorably described dangers the United States was facing in Iraq as consisting of known knowns, known unknowns, and unknown unknowns. It can be helpful to examine the risks of extending credit to scrap buyers using that same set of categories. When making that decision, you evaluate what you know—and what you don't know—about that customer and the conditions surrounding the transaction. Together, those two categories of information help you evaluate your expected risk. But every transaction faces unknown unknowns as well: Despite your best research efforts, a natural disaster, political or economic crisis, or business failure could leave you with delayed or missing payments for your scrap. That's unexpected risk.

The risks are more numerous and more severe now than they were even a decade ago. Greater volatility in the commodity markets, globalization, and private equity investment in scrap-consuming companies are among the factors that have created a more complex landscape, which has made the decision of whether to extend credit to a customer an increasingly complicated one. The days of relying on a handshake to guarantee payment for the material you sell are, unfortunately, a thing of the past.

Fortunately, risk-management tools can help scrap companies evaluate and mitigate such risks. Credit reporting services and credit insurance can help you identify risk factors and adjust your risk-management strategy to mitigate losses or even steer clear of hazards that could jeopardize your company's bottom line.

THE PERILS OF PRIVATE EQUITY

Though many in the scrap industry equate greater risk with overseas scrap transactions, changes in the domestic business landscape over the past decade can make those scrap deals more worrisome as well. One development scrap sellers should be wary of, for example, is the growth of private equity investment in the scrap industry in recent years, as fund managers and other investors have seen the industry's potential for profit. As a July 2011 *American Metal Market* article pointed out, after the recession, when private-equity firms were seeking higher returns in a persistent low-interest-rate environment, they viewed the metals industry as an attractive investment. The article's author correctly predicted such investment would increase. Although the influx of cash could seem like a positive development, part of the appeal is the industry's vulnerability: Some scrap companies are finding it more difficult to operate amid increased environmental regulation and government intervention, making them potentially attractive takeover targets.

When you learn a potential trading partner has taken on private equity investment, keep three additional risk factors in mind. The first is the lack of financial transparency: Private equity firms typically don't like to disclose financial information about the companies they own, which makes it difficult to get a clear picture of their credit risk. The second is the risk of debt-financed recapitalizations. Shortly after an acquisition, private equity firms often reward themselves with sizable dividend payments by borrowing against the assets of the acquired company. Doing so leverages their balance sheet and reduces the shareholders' at-risk capital, but it also loads the acquired company with debt, putting it at increased risk of default if, for example, the scrap industry experiences economic challenges or if other developments adversely affect the company's ability to maintain profitable operations. This relates back to the first concern because a lack of financial transparency could obscure a company's debt, making it challenging to gather information to help you decide whether or not to extend credit to such a company.

Moody's (New York) reported that debt recapitalizations continued at a strong pace throughout 2013, albeit at a slower rate than 2012's record-breaking year. In this industry, we've seen debt-financed recapitalizations most often among scrap consumers. For example, one large global aluminum company filed for bankruptcy in 2009, paid unsecured creditors pennies on their claims, and emerged as a reorganized company less than 18 months later with a clean balance sheet backed with private equity. Since then, the company has recapitalized, adding significant debt back on the aluminum company's balance sheet, and used most of the proceeds to fund more than $800 million in dividends to private equity shareholders. The aluminum company now has over $1 billion in debt, most of which was not used to reinvest in the business.

The third concern is that private equity investors have less "skin in the game"—the scrap or scrap-consuming company might be a small part of their holdings, thus their knowledge of or interest in the company might be limited to its potential to provide short-term value. Further, if a stakeholder in a company has no financial risk, that stakeholder tends to be less concerned with any developments that could result in default. And if investors have already cashed out with big dividend payments, they might be less interested in whether the company succeeds or fails than would business owners that have their own money on the table. That said, all investors are different. Some invest a considerable amount of equity in the business, do not take on much debt, and become committed to the company's overall success.

GLOBAL RISK FACTORS

Although U.S. manufacturing has staged a measurable comeback since the 2008 recession, the economic growth of foreign markets such as India and China continued unabated while North America and Europe were faltering, making them absolutely essential to the scrap industry. Trade between the United States and China in particular has been robust. For the past decade, scrap has been one of the United States' largest exports to China by volume. It has been a match made in heaven: Containers filled with Chinese-made consumer goods flood the United States; we fill the containers with scrap for their return trip; then Chinese firms process the scrap into even more goods to export to us. Scrap companies want to offer competitive terms to potential customers in China and other countries to win their business, but there are inherent risks involved when extending credit to customers abroad.

Perhaps most obvious, if a customer in a foreign market files for bankruptcy, it's more challenging to chase recoveries than it would be with a domestic customer. Also, you might feel the need to offer more favorable terms than the situation warrants because you might be competing against suppliers within the customer's country who have the benefit of government subsidies. Volatile political environments in many regions add another layer of risk to any open-credit, cross-border transaction. (U.S. scrap-consuming facilities with parent companies based in other countries also can be affected by such events.)

Even if you're confident of your risk assessment of a specific customer, as global markets have more fully integrated, events almost anywhere on the planet might affect supply and demand in such a way that leads a customer to default on payment. Whether it's an overcapacity issue, a drop in demand from overseas markets, a natural disaster that interrupts trade, or a sudden change in currency value, your credit risk is no longer insulated from global pressures, even if you don't export.

COMMODITY MARKET RISKS

Another factor in credit risk management is the increased volatility in the commodity markets. While it's true that supply and demand largely determine scrap market prices, the markets for the underlying commodities are vulnerable to speculative trading actions. Even when scrap commodities don't have formal futures markets, such as ferrous scrap, companies speculate when they increase or decrease their inventory levels based on anticipated orders; therefore, market expectations can have a significant impact on pricing. Seasonal variations and market bubbles can play a role as well. Any kind of quick, severe price correction can increase the risk of unexpected default if a company is overexposed to higher-priced inventories in a declining price environment. That was the situation many companies faced in 2008 and 2009, which resulted in increased insolvencies and slowed payments.

Market manipulation also can increase uncertainty and price volatility. Regulators in the United States and abroad have taken a great interest recently in the metal exchanges and warehouses, investigating policies and procedures that allegedly drive up prices by slowing sales or deliveries.

An additional downside of market volatility is the speed with which lenders become

RISK MANAGEMENT RESOURCES

The following ISRI-member companies are among those that provide credit reporting services and credit insurance to the scrap industry.

CREDIT REPORTING SERVICES

Euler Hermes, subsidiary of Allianz (Owings Mills, Md.)
www.eulerhermes.us ■ 877/883-3224

ProfitGuard (Bingham Farms, Mich.)
www.eprofitguard.com ■ 866/990-1099

CREDIT INSURANCE

Euler Hermes, subsidiary of Allianz (Owings Mills, Md.)
www.eulerhermes.us ■ 877/883-3224

Global Commercial Credit (Bingham Farms, Mich.)
www.gccrisk.com ■ 248/646-9400

HUB International Insurance Brokers & Consultants (Los Angeles)
www.hubinternational.com ■ 310/568-7626

Markel (Glen Allen, Va.)
www.markelcorp.com ■ 804/565-1905

MJ Insurance (Indianapolis)
www.mjinsurance.com ■ 317/805-7500

Recycle-Pro Insurance, Hibbs, Hallmark & Co. (Tyler, Texas)
www.recycleproinsurance.com ■ 903/561-8484

G.J. Sullivan Co. (Orange, Calif.)
www.gjsullivan.com ■ 714/621-2300

disenchanted with the sector and curtail their financing activity. In some cases, lenders pull credit lines, forcing borrowers to find other capital resources. From a credit-risk-management perspective, this, too, can result in sudden, unexpected insolvencies, as it did for many scrap companies in the fourth quarter of 2008, after the previous three quarters had been their best ever.

Despite the many factors that can put a company—or an entire industry—at risk of financial default, much of this risk is manageable, allowing you to extend credit to your customers without jeopardizing your company. A credit reporting service can help you address expected risk; credit insurance can help protect you from unexpected risk.

KNOWLEDGE IS POWER

Expected risk is readily identifiable and manageable with the right information and good decision-making. For example, reviewing the credit metrics from the financial statements of a publicly traded company will yield a good amount of clarity on the risk level associated with extending open credit terms to that company. As a matter of prudent business practice, you should be gathering information on the financial standing of your customers. You could ask potential customers to fill out a credit application so that you can check their bank and trade references, financial statements, and historical payment trends, for example.

Depending on the size of your firm and your role, however, you might not have the time or resources to conduct detailed investigations, intelligence-gathering, and risk analysis for every account. Also, it's often either feast or famine: Either you don't have enough information to make a decision on an account, or you're overwhelmed by the sheer volume of financial data. Credit reporting services give you the option to cost-effectively outsource some or all of this effort by providing objective guidance on proper credit limits and sales terms.

A credit reporting services firm should possesses the technology, along with the expertise of industry-specific analysts, to pull together disparate pieces of information into timely, reliable, targeted guidance. Ideally, the information provided will include a recommended credit limit, a probability-of-default rating, and a concise analysis of key factors the company used to set those limits and ratings. The company also should be able to adapt its offerings to the size and scope of your business. My firm, ProfitGuard (Bingham Farms, Mich.), is currently the only credit-risk-management firm that specializes exclusively in the metals sector; other companies provide credit reporting services in a broad array of industries.

When evaluating credit reporting services, ask to see sample reports, and find out whether they can customize a program to fit your needs and your budget or only offer broad services at set rates. When comparing prices, also compare the quality of information and value you receive for the price to find the best fit for your company.

PREPARING FOR THE UNEXPECTED

Unexpected risk is exactly that—unexpected. In spite of everyone's best efforts, defaults and insolvencies can happen suddenly and without warning. Though they're not as common as the more easily identified deteriorating risk situations, they can have a much more dramatic impact because you don't have the opportunity to react. There's no time to reduce exposure, pull back shipments, or take other defensive measures. To prevent or reduce your losses in such cases, you can implement a risk hedge like credit insurance, also known as trade credit insurance or accounts receivable insurance.

Credit insurance is a policy you can buy to cover the credit you have extended on specific accounts, which will indemnify you if an insolvency or past-due default occurs on that account. It can cover both domestic and international receivables, and policies on the latter also can include political-risk coverage for broader protection. These types of policies are not financial guarantees. Terms and conditions apply, and coverage does not extend to all circumstances, like exchange-rate losses or situations where it's legally determined that the customer does not owe you money.

Credit insurance is typically priced on a premium rate multiplied by your insured sales volume over a 12-month policy term. This ties your investment to the actual sales volume you're insuring. The coverage can be a cost-effective means to accomplish several important objectives: safely extending open-credit terms to large accounts, establishing appropriate levels of credit for new customers with whom you have little experience or knowledge, and leveling the playing field when competing against foreign scrap suppliers that have government support by allowing you to extend competitive open-credit terms. Insuring the larger exposures in your accounts-receivable portfolio can eliminate or at least significantly reduce the impact of a large, unexpected credit loss. It also can enhance your working capital availability in situations where you borrow against your receivables. You might be able to increase the advance rates your lender allows, include export accounts receivable in the borrowing base, and put slower-paying accounts back in the eligible borrowing base.

A limited number of insurance carriers offer credit insurance, and each has its own risk appetite, underwriting approach, and compliance requirements. You are likely to find that your property and casualty agent has not worked with this type of coverage, given its highly specialized nature. A broker that focuses solely on credit insurance can help you see all of the viable options and select a solution tailored to your needs. Global Commercial Credit (Bingham Farms, Mich.), a sister company to ProfitGuard, is one such broker to the scrap metal sector; others brokers are in this market as well. Although no solution will protect your company against every possible risk, a properly structured and managed credit insurance program is a powerful tool. When combined with an effective credit reporting service, the two can help mitigate losses when extending credit to customers.

While there is no shortage of hazards that directly affect your customers' ability to pay, the ideal strategy uses both information and a hedge against losses to protect your company against known and unknown risks. S

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