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CREDIT RISK NEWSLETTER

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Weaker Economic Outlook Could Stall Auto Recovery

Macroeconomic issues such as supply chain bottlenecks and inflationary pressure have been adversely impacting the automotive industry recently and is expected to continue through 2024. Although automotive demand has been solid this year, sales volumes have been negatively impacted by supply chain shortages and challenges caused by the Russian-Ukraine conflict with flat growth expected for 2022. Rising costs are putting pressure on margins and pushing the probability of bankruptcies higher.

Mild recessionary conditions in the U.S. may lead to a contraction of automotive demand in 2023 as consumers deal with higher interest rates. An even sharper contraction in demand is expected in Europe due to the impacts of the Russian-Ukraine conflict. The prospect of sales volumes recovering to pre-pandemic levels could take until 2025.

Disruptions to the automotive supply chain, mainly from semiconductor chip shortages, continue to impact the industry with uncertainty on any improvements in the near term. Although the shortages are expected to persist in 2023, it is likely that they will be less severe than what we have seen over the past couple of years. The supply chain issues have been increasingly difficult following the Russian-Ukraine conflict and tensions building around Taiwan and North Korea.

High inflation is another problem plaguing the automotive industry with higher costs placing pressure on margins and cash flows. Rising costs have led many automotive suppliers to file bankruptcy or threaten to

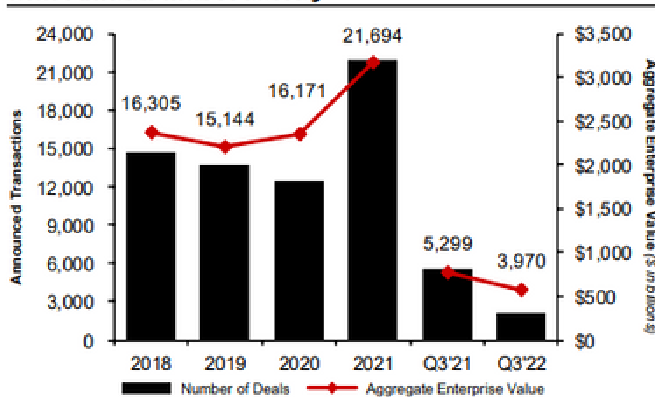
file bankruptcy in connection with price increases. At least five automotive suppliers have filed for bankruptcy in the past few months. Suppliers locked into contracts entered prior to the pandemic have turned to bankruptcy filings or the threat of filing when they cannot pass through costs to customers. Bankruptcy provides the opportunity to exit the situation legally or, when used as a threat, can lead to renegotiating pricing contracts. These bankruptcies could have a ripple effect on the entire automotive supply chain. In the automotive industry, suppliers occupy three Tiers—Tier 1, 2, and 3. Tier 1 suppliers supply parts or systems directly to OEMs, Tier 2 supply parts that wind up in cars, even though these firms themselves does not sell directly to OEMs, and Tier 3 refers to suppliers of raw, or close-to-raw, materials like metal or plastic.

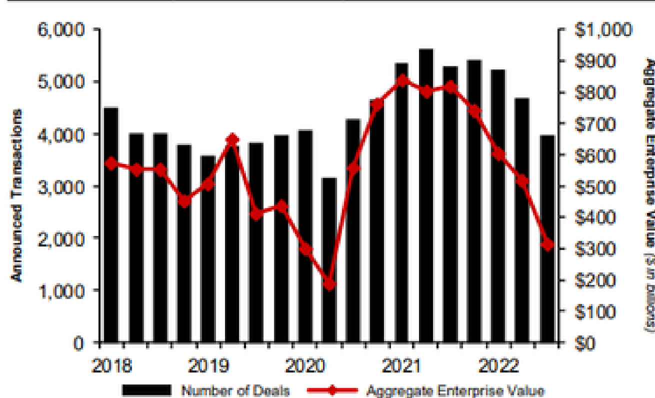
With all the economic uncertainty and recessionary conditions lingering, credit risk is on the rise. Credit managers should be looking to increase the frequency of reviewing customer credit quality as volatility can lead to sudden changes in risk and reverberate through supply chains.

Deal Making Activity Slows

Overall M&A activity declined in 2022 as central banks raised interest rates to combat inflation. It is important to understand this comes after record levels of M&A deals in 2021. Nonetheless, elevated interest rates and lower equity valuations will likely keep companies on the sidelines in the near term.

KeyBanc Capital Markets reported that U.S. Q3 2022 transaction volume was down 25.1% year over year as concerns over economic conditions, ongoing geopolitical tensions, and a sustained inflationary environment dampened activity. Transaction volume declined year over year in the consumer, industrial, healthcare, and technology sectors. Furthermore, the total value of M&A announcements has dropped considerably. Through the first three quarters of 2022, the total announced value of global M&A transactions plummeted 35.6% year over year to $2.285 trillion.





Source: KeyBanc Capital Markets

Small Business Outlook

The National Federation of Independent Business (NFIB) Small Business Optimism Index rose 0.6 points in November to 91.9. November's reading is the 11th consecutive month below the 49-year average of 98. The NFIB Small Business Optimism Index provides an indication of health of the small businesses in the United States.

"Going into the holiday season, small business owners are seeing a slight ease in inflation pressures, but prices remain high," said NFIB Chief Economist Bill Dunkelberg. "The small business economy is recovering as owners manage an ongoing labor shortage, supply chain disruptions, and historic inflation."

Businesses remain cautious about adding to inventories and hiring and will likely delay construction and other capex plans with credit more expensive and order books shrinking. Only 55 percent of owners reported capital outlays in the last six months and only 24 percent plan capital outlays in the next few months. Overall, capital spending remains too weak to improve productivity.

Turning to 2023, we could see an increase in distressed sellers that would keep M&A activity steady, albeit at lower levels. As stated by Willis Towers Watson, "the difficult operating environment will drive an increase in companies jettisoning non-core assets in the pursuit of long-term value creation. This can create opportunities for buyers to expand product lines, services, or supply chains at a reduced rate." S&P Global Ratings further elaborates that for much of 2022, M&A has become less appealing for many private equity firms because the higher cost of debt makes it more challenging to reach return hurdles using leverage. However, the private equity (PE) industry has plenty of dry powder and will look to put it to use. Resilient corporate balance sheets will also come into play.

With continued high levels of PE dry powder, we note private equity ownership can impact the credit quality of the acquired company. One of the main risk factors typically associated with private equity ownership is leverage. PE firms usually employ aggressive financial policies that lead to leveraged balance sheets and potentially unsustainable capital structures. The PE sponsors will use leverage for bolt-on acquisitions or to garner large returns for shareholders. Another risk factor we typically see once PE firms acquire a company is a lack of financial disclosure. It is uncommon for private equity firms to publicly disclose or share relevant financial information. Without this data, it is difficult to fully assess a company's risk profile. If your customer is acquired, it is important to complete a fresh credit review as its risk profile has likely changed.

The bottom line is that with recessionary fears growing, M&A activity will likely slow down, but there will still be deals in the pipeline for companies with strategic discipline. M&A deal activity will likely come from companies that are looking to shore up their balance sheets and return capital to shareholders.

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