ProfitGuard
Know The Risk *Before* You Ship

CREDIT RISK NEWSLETTER

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MANAGING CREDIT IN 2023

We know credit risk management isn't an exact science, especially with new risks constantly emerging and reshaping the state of corporate credit. However, we wanted to point out three things you should be thinking about as you approach customer trade credit in 2023.

1 Refinancing pressure is building

Companies continue to deal with elevated input costs and waning demand amid the prospects of a downturn. The Federal Reserve is still fighting inflation, which will likely cause borrowing costs to increase further. This will pressure some corporate borrowers as maturities near.

As such, now is the time to source updates on your customers liquidity and debt information. Cash is still king, and liquidity remains a key metric. Ideally, you should be sourcing bank/debt updates every 6 months, even sooner if your customer is higher risk.

2 Warning signs

Is your customer getting harder to get a hold of or has communication ceased altogether? Has your customer stopped providing financial and liquidity disclosure? Are old customers now interested in buying again? Are you being paid late or are past due? All of these could spell trouble.

3 Your customer's customer

Over the last few years, the pandemic has shown us that supply chain risk is real and disruption can have a significant impact on credit risk. Most credit professionals know it makes sense to monitor the condition of their customers to avoid potential credit losses. Taking the analysis a step further, keeping an eye on your customer's customer might be a good idea as well.

Bankruptcies, force majeure, political tensions, cybersecurity breaches, pandemics, and more can cause supply chain disruptions. Having a structured policy that allows you to catalog and address these supply chain risks can help improve your risk management practice in general. In your analysis, what you are really looking for is if any of your customers' customers are weak financially. Secondly, if you know any of your customers' other suppliers, you could keep an eye on those companies as well. Obviously, you are not looking to triple your credit risk management workload, but it may be prudent to monitor these risks on your key customers or top accounts where there is known high concentration or exposure to the entity.

"TEXAS TWO-STEP" MANEUVER UNDER SCRUTINY

With an uptick in mass tort litigation, financially sound companies are spinning off business units and placing them into bankruptcy to reach settlements through bankruptcy courts rather than in front of juries.

As explained by Bloomberg Law, "The Texas Two-Step maneuver involves a company spinning off a unit and transferring its tort liability to that unit, usually via a Texas corporate law that allows so-called divisional mergers. The spinoff is then put into bankruptcy to manage that liability without putting the assets of the original company into play." However, a recent Third Circuit court decision is creating legal uncertainty for financially healthy companies eyeing Chapter 11 bankruptcy to head off mass tort liability.

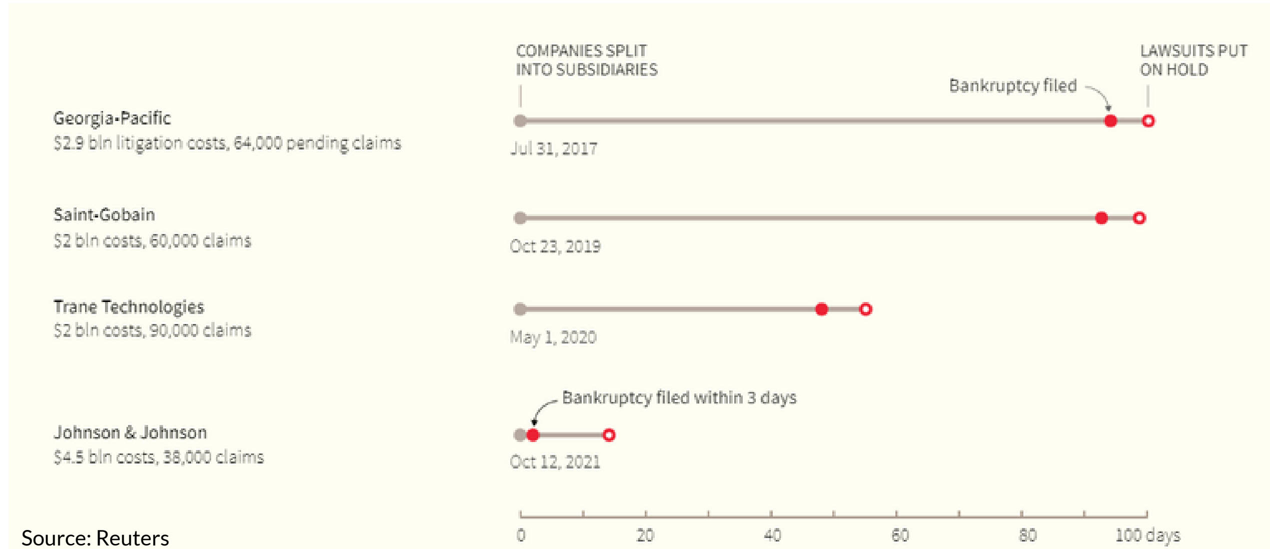
U.S. HIGH-YIELD DEFAULT RATE INCHES HIGHER

Despite a recent Fitch Ratings report indicating that high-yield default rates remain relatively low, they are poised to rise this year.

The trailing 12-months U.S. high yield default rate stands at 1.5%, but is forecast to end 2023 within the 3.0-3.5% range, which would be above 2021 and 2022 rates. Consumer oriented sectors, such as retail and leisure/entertainment, could see more defaults this year as consumer pressure mounts.

In its Fitch Wire report, Fitch's economics team stated that they, "expect consumer spending growth to slow in 2023, as the Fed's aggressive tightening cycle increasingly weighs on job growth and consumer demand in 2023. Additionally, we see some risk of the Fed adopting a more aggressive-than-expected interest rate policy, possibly in response to sustained wage pressures or a reversal in the disinflationary trends of recent months, which poses risks to consumer spending in 2023."

The Texas Two-Step arose in 2017 when Georgia-Pacific, a Koch Industries company, created a subsidiary unit to offload its asbestos litigation liability through bankruptcy. Worthington & Caron explains, "The controversy here is that Georgia-Pacific paid out approximately $2.5 billion in dividend payments in 2022 to its corporate conglomerate Koch Industries. The Texas Two-Step is a blatant misuse of bankruptcy proceedings and allows these companies to halt court proceedings and delay justice for asbestos cancer plaintiffs while raking in massive profits."



Source: Reuters

Times might be changing because the Third Circuit court dismissed the bankruptcy of LTL Management, a subsidiary of Johnson & Johnson, on the grounds that it was not in financial distress. It further stated that J&J had agreed to fund LTL's liabilities up to $61.5 billion. The judge also noted that J&J had over $400 billion in equity value, a AAA credit rating, and $31 billion in cash and marketable securities. The company also distributed more than $13 billion to shareholders in both 2020 and 2021. According to Reuters, even if Johnson & Johnson settled all their pending court cases it would cost the company approximately $5.5 billion, which would still not cause the company financial distress.

This development is something to keep an eye on as it could impact the credit worthiness of large corporations that are facing mass tort liability.

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