

CREDIT RISK NEWSLETTER

In this newsletter:

Credit Guidance: Cross-Default Clauses

Page 01

Weak PMI Pressuring Manufacturing Sector

Page 02

Wider Credit Spreads, Rising Defaults Forecasted

Page 02

CREDIT GUIDANCE: CROSS-DEFAULT CLAUSES

Most businesses rely on a mix of debt and equity to operate. To get a complete picture of your customer's credit risk, it is important to understand its debt instruments and how they are structured. In commercial loan documents, cross-default clauses can be common, which can have a significant impact on a company's overall risk rating.

First, what is a cross-default clause? As explained by Thomson Reuters, "a cross-default clause operates by automatically defaulting a borrower under Agreement A when it defaults under Agreement B. A cross-default provision effectively gives the lender under Agreement A the benefit of the default provisions in Agreement B. Cross-default provisions therefore have a domino effect." Essentially, a borrower is in default under the current loan if the borrower defaults on another loan and the lender can take all necessary actions to call the debt and demand repayment. If a cross-default clause is triggered, debt obligations under a credit agreement could become immediately due and payable even if there is no breach of covenants or payment default on another debt obligation, like a company's ABL or Revolver, which could cause a liquidity crisis. A cross-default clause is a tool that is utilized by lenders to call a loan in default when a related loan is not performing, so that all loan defaults with a common principal can be dealt with at one time.

To uncover a cross-default clause, you will need to review different sources. If your customer is publicly traded, debt/credit agreement documents will be listed within their SEC filings. For privately-held customers, cross-default clauses might be listed in the company's audited financial statements, or you might just have to ask management for those details. Either way, it is critical to understand how your customer's debt is structured.

As a recent example, we can look to Briggs & Stratton. In 2020, Briggs & Stratton skipped its June 15th interest payment; failure to pay the coupon would have resulted in an event of default under its senior notes and a cross-default under its ABL credit agreement. This would have given the lender the right to call on all Briggs & Stratton debt. On July 17, 2020, the company received a waiver from its lender that prevented a cross-default after the company's failure to make a bond interest payment became an event of default. However, the company's debt burden was unsustainable and it had significant liquidity issues that led to its Chapter 11 bankruptcy filing on July 20, 2020.

With the potential for a domino effect, cross-default clauses significantly impact a company's credit risk. Understanding a company's debt structure will provide a 360-degree view and will help you make more informed credit decisions.



WEAK PMI PRESSURING MANUFACTURING SECTOR

Global PMI indexes continue to signal persistent and widespread reductions in business activity across the majority of sectors. The J.P. Morgan Global Composite Outlook index posted a reading of 48.2 in December, per S&P Global. A reading under 50 indicates a contraction, and this marked the fifth consecutive month of global contraction.

Despite a slightly higher reading than in November, the outlook continues to remain uncertain with weak demand conditions remaining at the heart of the slowdown. According to S&P, "global new orders lowered for a fifth month in December, dropping at the steepest rate since 2009, barring pandemic lows, boding ill for output in the coming months."

WIDER CREDIT SPREADS, RISING DEFAULTS FORECASTED

The latest Credit Outlook survey from the International Association of Credit Portfolio Managers (IACPM) found that credit portfolio managers are overwhelmingly forecasting rising corporate defaults globally over the next 12 months, with 88% of respondents saying defaults will increase in North America. Survey respondents are also forecasting wider credit spreads globally over the next three months.

The survey is to create a quick snapshot of current credit risk views and provide an information base for IACPM members to discuss likely evolutions of the credit cycle over time.

While respondents pointed out that defaults remained low last year despite higher inflation and rapidly rising interest rates, rising corporate defaults globally will likely take hold.

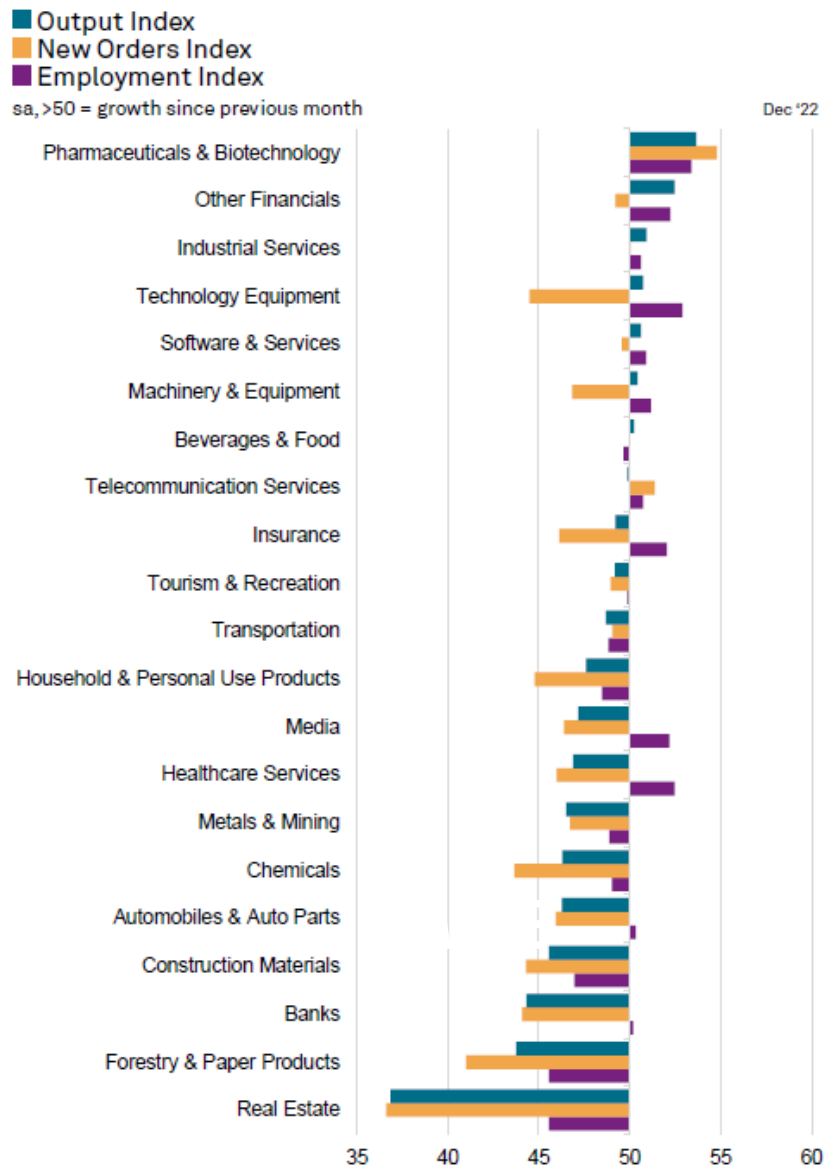
"After more than 15 years of exceptionally low interest rates and few defaults, we now have higher interest rates," commented Som-lok Leung, Executive Director of the International Association of Credit Portfolio Managers. "But, as we're seeing, it's taking time for defaults to rise. "

For the United States and Canada, the PMI readings for December were 46.2 and 49.2, respectively. "The Canadian manufacturing economy remained in mild contraction territory during December, characterized by further falls in output, new orders, and purchasing activity. Inventories were drawn down as firms sought to realign stocks with current production requirements."

Demand has eased overall due to rising interest rates and continued high inflation. ISM states "Business is slowing down and forecast to decrease by the end of the first quarter or second quarter" for the fabricated metal products. However, the silver lining is that December data showed cost burdens softening. As S&P mentioned, "Respondents said lower prices for fuel, metals, and oil-related products dampened the overall upturn in operating expenses." In turn, this has resulted in manufacturers passing some of those savings to consumers to stimulate sales. Decreasing prices is viewed as a positive factor in this case, as it signals to the Federal Reserve that inflation is trending downwards.

Nevertheless, rising interest rates, geopolitical and economic uncertainties, and an overall tightening credit environment will continue to pressure companies.

Sector PMI Breakdown



Source: S&P Global.

PROFITGUARD LLC

30200 Telegraph Rd.
Suite #450
Bingham Farms, MI 48025

T: 1-866-990-1099
www.eprofitguard.com