

CREDIT RISK NEWSLETTER



Recent Events Impacting Credit Risk

Credit conditions are tightening and will likely place pressure on credit quality moving forward.

Inflation surged higher than expected in June, increasing 9.1% over the last twelve months. In response, the Fed raised interest rates by 0.75% at its July meeting. This is the central bank's second 0.75% hike in recent months, and it will consider another large increase at its September meeting. This takes the target Fed Funds rate to 2.25%-2.50%. At the same time, Fed Chairman Powell stated: "These rate hikes have been large, and they've come quickly. And it's likely that their full effect has not been felt by the economy so there's probably some significant additional tightening in the pipeline." The Bank of Canada raised its policy rate by a full percentage point at its last meeting, lifting the rate to 2.50% from 1.50%, the biggest one time increase since 1998. Central banks are urgently raising rates while understanding this could trigger a sharp slowdown in growth, a decline in asset prices, and lead to a recession. Comerica Bank also reports that financial markets are pricing in the possibility of interest rate cuts next year, another sign of recession fears.

As reiterated by ISRI's Chief Economist Joe Pickard, "This means loan rates will continue to increase into the future from their near historically low levels. Costs will increase for equipment and machinery purchased with adjustable rates and under lines of credit. As operational costs have increased and will likely continue to increase for some time period (labor, capital, etc.), an added incentive to merge or acquire other operations to reduce costs is likely to continue."

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Merger And Acquisitions

Tightening credit conditions and elevated inflation will likely influence the M&A landscape for the remainder of 2022. There are certainly deals in the pipeline, but M&A activity could start to slow as interest rates rise and enterprise valuation multiples decline. M&A activity was relatively stable in the first half of 2022, especially in the Industrial Manufacturing, Metals, and Plastics/Packaging segments. While deal-making activity was actually down in the first half of 2022, this is compared to record high levels in 2021.

Recent note-worthy deals include:

On July 13, Charlotte Pipe and Foundry announced their acquisition of Wisconsin-based Neenah Enterprises, Inc. The company, which produces construction industrial castings, has plants located in Florida, Nebraska, and Wisconsin. Additionally, the 150-year-old company is in the process of completing a fourth location in Charlotte, North Carolina – this foundry is expected to begin operations in 2023 Q3. The acquisition will put Charlotte Pipe in a stronger position to produce iron castings. “This acquisition in an adjacent sector builds on our core competency in the manufacturing of grey iron castings. We believe that Charlotte Pipe's financial strength and manufacturing expertise will strengthen Neenah's portfolio,” President and CEO Hooper Hardison said in a press release issued by the company. The move comes as gray iron castings' price has seen an increase throughout 2022, sitting at 134.34 in June. This is up from 128.84 in January of this year, and is expected to continue on its upward trend for as long as rate hikes and supply chain disruptions persist.

Thunderbird LLC acquired Bright Plastics of Greensboro, NC to expand its injection-molding support for a range of industries. These include medical, defense, aerospace, transportation, recreation, waste management, and telecom. In May, Thunderbird acquired MPR Plastics, an injection molder based in Elgin, IL. It also acquired Williams Plastics in 2017, Indiana Plastics in 2018, and the plastics division of Tuthill Corp. in 2020.

Majestic Steel USA, a steel service center, completed two strategic acquisitions in manufacturing and logistics. On July 14, the company reported that Quicken Steel LLC, a manufacturer of steel buildings and components based in Claxton, Georgia, and Mercury Transport Inc., a transportation company based in Pittsburg, California, will become a part of Majestic Steel USA, Inc. The acquisition of Mercury Transport is a follow-on investment to Majestic's 2021 acquisition of Merit Steel USA, a West Coast-based steel service center.

On July 1, ArcelorMittal acquired 80% of voestalpine Texas, a Hot Briquetted Iron (HBI) plant located near Corpus Christi, TX, with an enterprise value of approximately \$1 billion. The transaction allows ArcelorMittal to vertically integrate via HBI production capabilities. Voestalpine AG will retain the remaining 20% stake in voestalpine Texas.

As companies continue to battle elevated input costs and supply chain issues, this has led to reduced production and temporary plant closures. Century Aluminum Company announced on June 22 that it will temporarily idle its Hawesville, KY smelter as a direct result of skyrocketing energy costs. The company reported the shutdown will last nine to twelve months until energy prices return to more normalized levels. Jesse Gary, the Company's President and Chief Executive Officer, commented, “This unprecedented rise in global energy prices arising from the Russian war in Ukraine has dramatically increased the price of energy in the U.S. and around the globe. The power cost required to run our Hawesville, KY, facility has more than tripled the historical average in a very short period.”

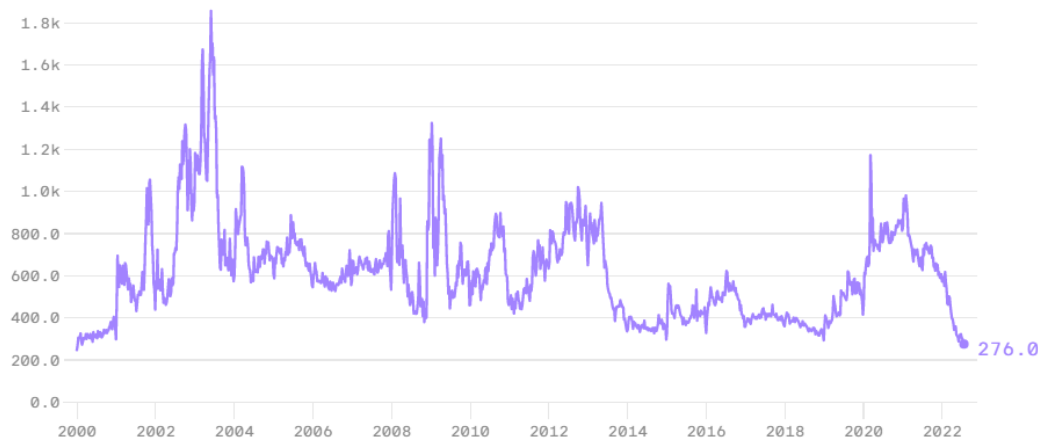
The Bureau of Labor Statistics reported June producer prices surged a near-record amount from a year ago due to a big jump in energy costs. The producer price index, a measure of the prices received for final demand products, increased 11.3% from a year ago. Of that gain, the majority came from a 10% increase in final demand energy costs as prices for oil, natural gas and other products soared.

Kaiser Aluminum declared force majeure at its Warrick Rolling Mill because of the limited availability of magnesium used in its production. Kaiser Warrick has been unable to immediately source additional magnesium from other suppliers and has begun adjusting production levels. The company reported that it “anticipates production and deliveries will be reduced by 30% to 40% in the month of July, and approximately 50% during the remainder of the third quarter.”

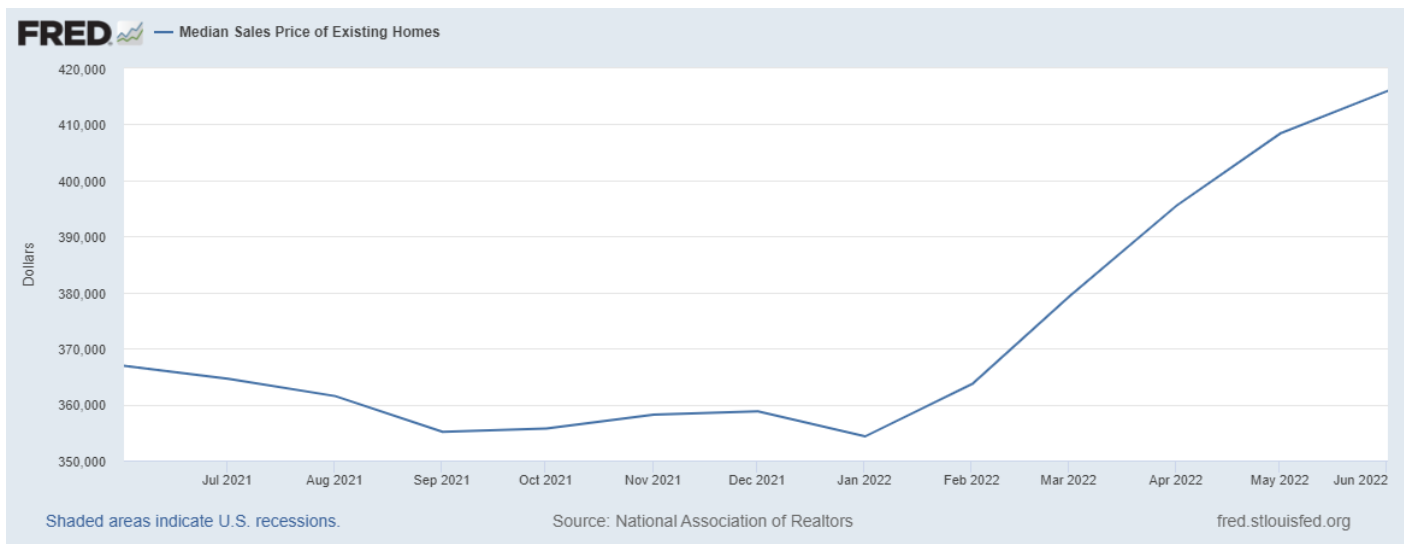
Lastly, we want to provide a brief update on the housing market, as it has come under extreme pressure from rising interest rates. Because of the recent rate hikes, mortgage applications have plummeted. As explained by Dan North, Allianz Chief Economist, the Mortgage Bankers Association of America’s mortgage applications index has fallen -6.3% in one week and is now down -60% y/y, the lowest in 22 years, even lower than when the housing market collapsed in 2008. Since mortgage applications have collapsed, so has homebuilder sentiment. “So the grim procession goes like this: inflation rises... Fed Funds rise... mortgage rates rise... mortgage applications fall... homebuilder sentiment falls... existing home sales fall... all capped off with the final misery of rising prices. It’s not going to get better.” We believe housing will likely be a headwind to GDP growth in the second half of 2022 and throughout 2023.

U.S. mortgage application index

100=March 1990; Weekly; Dec. 31, 1999, to July 22, 2022; Includes purchases and refinances



Data: Mortgage Bankers Association; Chart: Nicki Camberg/Axios



Shaded areas indicate U.S. recessions.

Source: National Association of Realtors

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What We Can Take Away From S&P's Credit Outlook Trends

Despite slowed economic growth and inflation continuing on an upward trend, company rating changes have remained relatively stable. This month, S&P reported the number of companies with a rating of 'CCC+' or lower actually decreased in June (131 companies) compared to May (135). This could be thanks to a push in the media and entertainment sector as the summer box office season and full reopening of amusement parks are in full swing. When you look at consumer products and capital goods, however, the downgrade risk becomes more apparent.

According to S&P Global Ratings, consumer products and capital goods with 'B-' ratings had a higher negative bias outlook than sectors like oil & gas, automotive, and retail – among others. The consumer goods negative outlook jumped from 6.2% in May to 7.8% in June. This means that analysts believe a company in this sector with a 'B-' is more likely to receive a downgrade than a company with the same rating in another sector. One can look to inflation and tightening margins – especially with impending rate hikes and growing fears of a recession – for the predominantly negative outlook on the capital goods sector. From this information, we can take away that prudent consumer behavior and revenue ceilings can be expected to tighten – as they have since the start of the new year. S&P also stated that supply-and-demand imbalances, including substantial raw material cost inflation and logistics challenges, could cause a slowdown in the pace of upgrades for Chemical companies over the next 12 months.

The U.S. Distress Ratio is another indicator that issuers are facing difficulties. Per the latest S&P data, the U.S. Distress Ratio rose to 9.2% on July 5 – its highest level since October 2020. This more than doubled what the distress ratio stood at on June 3, when S&P reported it at 4.3%. This figure typically coincides with an uptick in default rates as companies face mounting pressure to navigate through price hikes, geopolitical uncertainty, and scaled-back consumer spending. Per S&P, the consumer products sector had eight distressed issues reported in June 2022, which is up from three reported distress issues in the previous month.

We note it's more important than ever to get ahead of default payment activity, as this behavior could persist and impact your company's bottom line.

Analyzing Credit Agreement Amendments

Credit professionals must look at several different variables of a company to get a complete picture of their creditworthiness. Perhaps one of the more important components to consider when evaluating a company is the borrowing relationship and/or debt agreements it has with a lender. After the borrower and lender execute a credit agreement, some situations arise where the original credit agreement needs to be changed. That's where credit agreement amendments come in. If you're familiar with debt capital, you'll know that amendments are quite common. A borrower and lender might modify (amend) an existing agreement for any number of reasons.

In most recent history, the COVID-19 pandemic led to a surge in credit agreement amendments to offer relief for borrowers. A majority of credit agreements require the borrower to adhere to certain financial covenants; despite this, the COVID-19 lockdowns resulted in many borrowers breaching their covenants. Credit amendments were initiated to waive the violations, change the financial requirements, or delay covenant



testing for a set time. According to Finley, a capital management solutions company, “The main reason that borrowers and capital providers execute amendments is to ensure that their credit agreement can stay in place. That can't happen, for example, when a borrower trips a covenant and is technically in an event of default. By altering the rules of the credit agreement, borrowers and lenders can ensure the preservation of the debt agreement that's already in place.”

Amendments also occur because of changes in regulatory framework, rising interest rates, changes in lender risk appetite, and macroeconomic shifts. For publicly-traded companies, credit agreement amendments need to be disclosed, so you can find the details in a company's SEC filings. Privately-held companies typically disclose amendment specifics in their annual reports, so you will need to source the company's financial statements to uncover these details. Once all details are secured, you can then understand how the amendment will impact the company's credit risk.

Last month Alcoa Corporation completed an amendment to its revolving credit facility that extended the maturity date from 2023 to 2027, which is credit positive. Ryerson also executed an amendment in June that extended the company's credit facility from 2025 to 2027 and increased the borrowing availability to \$1.3 billion from \$1 billion, both positive credit factors. On June 14, 2022, Century Aluminum entered into an amendment that increased the size of its revolving facility to \$250 million from \$220 million, extended the maturity to 2027, and replaced Libor with Sofr as the benchmark interest rate. This improves the company's borrowing capacity and debt maturity schedule.

Depending on the situation, either the borrower or lender may have more leverage in the negotiation of the credit agreement amendment. Finley states that borrowers might agree to a credit agreement amendment in order to maintain access to their source of working capital, while private credit funds might agree to a credit agreement amendment so that they can continue to put capital to work (rather than jeopardize an existing deal).

Amendments happen for a variety of reasons and it is important to understand the credit implications if your customer executes a debt capital amendment.

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