

CREDIT RISK NEWSLETTER

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DOWNGRADES OUTPACING UPGRADES IN 2023

As costlier financing terms, dwindling profitability, tightening lending standards, and overall economic uncertainty weigh on corporate credit, downgrades are outpacing upgrades so far this year.

ProfitGuard has downgraded 86 companies through the first five months of 2023, compared to 35 over the same period last year. Fitch Ratings reported a similar trend, with North American corporate downgrades exceeding upgrades during the first quarter of 2023, due in large part to changes in financial profiles. S&P downgrades surged to 77 globally in March, the highest monthly total since June 2020. Although speculative-grade issuers, particularly those rated 'B-' and lower, continued to lead downgrades, investment-grade downgrades also rose, more than doubling to 16 in March from 7 in February. It is also worth noting that the number of negative outlooks and CreditWatch revisions rose by 56% in the first quarter of 2023 and downgrades are expected to continue to increase. By sector, the consumer products segment continues to have the largest number of potential downgrades, with 98 globally.

A range of factors contributed to these downgrades, including:

- Weaker operating performance
- Deteriorating liquidity
- Uncertain refinancing prospects
- Expectations for continued deterioration in financial metrics

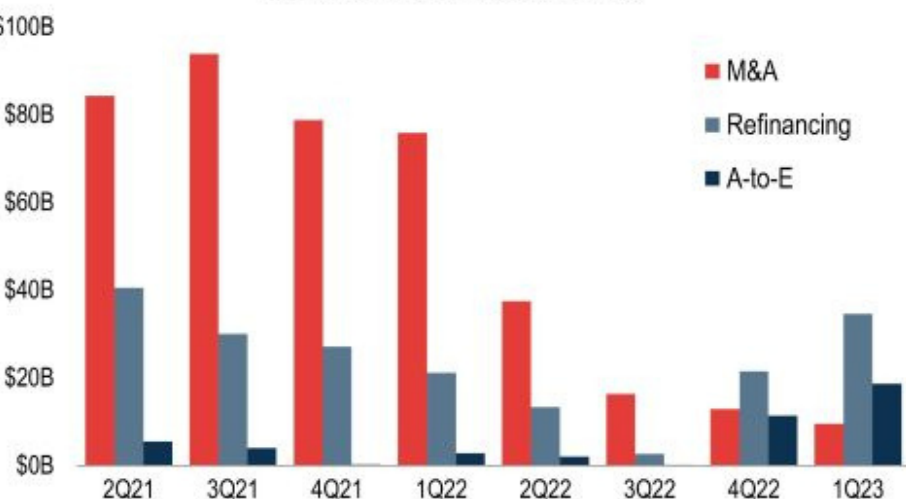
The trend of downgrades outpacing upgrades is likely to continue in 2023. Credit professionals should be aware of this trend and take steps to mitigate exposure on higher-risk accounts.

AMEND-AND-EXTEND ACTIVITY ON THE RISE

Amend-and-extend (A&E) activity has gained increasing importance in credit markets as a tool for borrowers and lenders to renegotiate existing loan terms. For borrowers, A&Es can provide a number of advantages. First, they can help borrowers to extend the maturity date of their loans, which can reduce near-term refinancing risk. Second, A&Es can allow borrowers to modify the interest rate on their loans, which can save them money on their interest payments. And third, A&Es can provide borrowers with additional financial flexibility, which can be helpful in times of economic uncertainty.

A recent report from PitchBook highlights the current market statistics on amend-and-extend loan volumes. Despite falling in March, activity remains robust, with the volume of amend-and-extend transactions reaching \$46.5 billion in the first quarter of 2023. By comparison, A&E volume in the first quarter of 2022 reached only \$12.3 billion. Recent amend-and-extend activity includes Dana Incorporated's \$1.15 billion extension of its revolver, Jo-Ann's Credit Agreement amendment that allows for certain trade receivables to be included in the borrowing base, and NN Inc.'s amended \$150 million term loan and \$50 million ABL, loosening covenants and opening the door to a junior capital raise. The report underscores the resilience of this loan restructuring strategy despite market volatility and suggests that borrowers and lenders are increasingly utilizing amend-and-extend to address potential liquidity concerns.

US institutional loan volume



Data through March 23, 2023

Source: PitchBook | LCD

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This A&E has helped chip away at the maturity wall of outstanding institutional term loans. 66% of loans that are due in 2024 carry ratings of B-minus or below, and 39% fell into the triple-C bracket as of March 17. That portends a continuation of extension activity in the year ahead as lenders work with borrowers to give them more runway.
 -PitchBook
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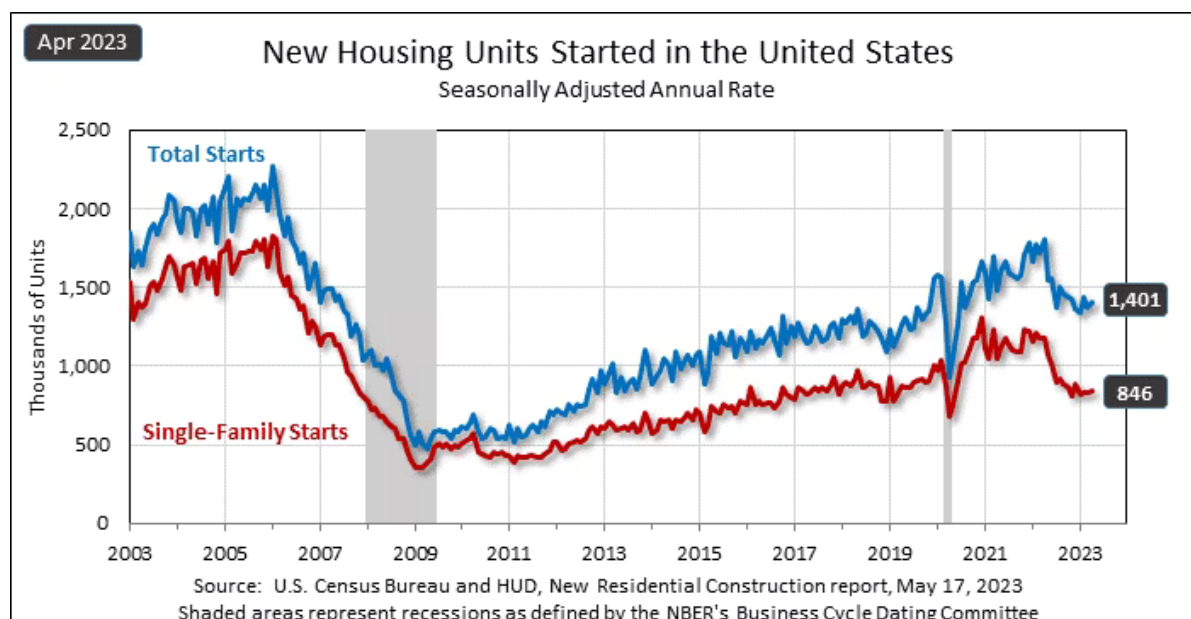
At the same time, covenant-relief transactions also experienced a sudden surge in March, with LCD reporting nine transactions, which is the most since December 2020. However, it is important to note that covenant-relief activity is down significantly from 2020 when companies ran to their lenders at the onset of the pandemic to get relief and improve financial flexibility. In all of 2022, there were just 42 covenant-relief transactions, this is compared to 193 in 2020. Covenant violations can have a significant impact on your customer's credit profile. "If businesses are not managing their covenants tightly, they will be inviting the bank to come in and collect their cash," states Prophix Software CEO Alok Ajmera.

Overall, we expect amend-and-extend activity to remain elevated in 2023 as borrowers look to put a dent in upcoming loan maturities. This proactive approach enables companies to navigate economic uncertainties, enhance cash flow management, and ensure that there are no unpleasant liquidity surprises. If your customers have upcoming debt obligations, this is something to keep an eye on.

PLASTIC MANUFACTURERS STILL FACE CHALLENGES IN THE CONSTRUCTION SECTOR



Housing starts in the United States have been on a downward trend, with the seasonally adjusted annual rate (SAAR) of starts falling to 1,401,000 units in April, which is 22.3% lower than the April 2022 rate of 1,803,000 units. Several factors played a part in the deceleration, including higher mortgage rates, elevated construction costs, and skilled labor shortages. As plastics play a crucial role in home construction, this decline in housing starts led to softening demand for pipes, flooring, wiring, siding, and other plastic inputs.



Despite the headwinds, the U.S. housing market is showing some improvement as of late. While the seasonally adjusted annual rate (SAAR) of housing starts fell to 1,401,000 units in April, it is 2.2% higher than the revised March estimate of 1,371,000 units. We also note new home sales in April increased 4.1% from March and that is almost 12% above new sales in April 2022. As reported by Moody's Analytics, "The modest improvement is consistent with recent NAHB Housing Market Index readings, which show that builders

are becoming cautiously optimistic. May's Housing Market Index was above the 50-point threshold marking good building conditions for the first time since July 2022, pointing to further improvement."

Labor and material costs also rose substantially in 2022 but are beginning to cool down. According to the most recent Associated Builders and Contractors (ABC) analysis, construction input prices are down year over year in April for the second straight month. "This PPI release provides some good news for an industry that has dealt with a nearly 40% increase in construction costs since the start of the COVID-19 pandemic," said ABC Chief Economist Anirban Basu.

The housing market is expected to bottom out and begin to recover, barring a significant economic downturn. This is due to a few factors including the expected slowdown in inflation, which will lead to lower interest rates. The 30-year fixed mortgage rate continues to hover in the mid-6% range, but will likely slowly decline in the second half of 2023 and throughout 2024. Moody's Analytics also states that house prices are forecast to fall 10% from peak to trough, which is a much smaller correction than in the previous housing bubble collapse in the 2000s. Lower house prices will be a plus for housing demand. Steady improvements should bode well for plastic manufacturers serving the construction segment.

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