Credit Risk in The Scrap Industry

The U.S. metals sector is bearing the brunt of a ‘perfect economic storm’ without truly knowing as yet whether the nation’s economy will suffer a soft or hard landing. In the following article, a specialist author believes the U.S. economic slowdown will persist for most of 2001, prompting him to urge scrap companies to focus on effective means of managing credit risk.

It appears as though the U.S. metals industry has entered the ‘perfect economic storm’. The industry is experiencing lower demand, high inventory levels, pricing pressure, and, most importantly, a flight of available capital. The ferrous markets have been hit worst of all, with 16 major bankruptcy filings in the U.S. during the last year alone. The non-ferrous sector has also begun to show signs of significant weakness, with several of the larger debt-ridden producers ending the fourth quarter of last year in the red.

My belief is that the U.S. economic slowdown will last throughout most of 2001. I base this on the following facts and assumptions:

- The earlier Federal Reserve tightening is still at work in the economy and I believe it will take at least one year for recent rate reductions to work their way through the system. Also, banks continue to operate conservatively and so are giving marginal/leveraged borrowers few options;

- Higher energy costs continue to work their way throughout the economy. Contracts are being renewed at much higher rates and this will continue to put pressure on profits;

- We need to absorb the higher inventories before manufacturing resumes at an optimal pace. This will make it hard for producers to pass on price increases or make them stick.

Unfortunately, the above does not offer any sign of short□term relief with regard to credit risk for U.S. scrap companies selling into this environment. Default rates will continue to be high until imports subside and demand picks up allowing price increases to stick. Many firms will be left in a vulnerable state because of the losses incurred since the Asian Crisis of 1997/1998.

Dealing with credit risk

In this type of economic environment, there are many credit risk factors at play. Most firms in the scrap industry have relied on personal relationships to manage their credit risk but this will no longer work - as many suppliers have recently found out the hard way. Every sale puts capital, profit and net worth at risk. Especially in the current environment, companies truly need to focus significant attention on this area of their business in an attempt to find an effective way to manage the risk.

Unfortunately, too many companies rely on historical payment experience as a means of managing credit risk. We have witnessed all too many bankruptcies where the debtor firm has continued to pay vendors in a timely fashion up until the filing date. This could result if you are one of the firm’s major suppliers, if they have current availability under their line (lender has yet to call the loan due), or the owners continue to put capital into the business waiting for things to improve.

Importantly, you not only have to be concerned about who you are selling to but also on who your customers are selling to, i.e. can they withstand a potential loss if one of their larger buyers were to default? This is one added layer of credit risk to which most firms pay little or no attention - at least, until it is too late.

Credit insurance is not an umbrella

The credit insurance marketplace in the U.S. is currently 'shut-off' to the metals industry. Several carriers have stopped accepting applications and several others are set to follow suit shortly. Credit insurance is a 'pro-active' tool - it needs to be implemented in good times when coverage approval can be secured. It is not an umbrella. You can't expect a credit insurance underwriter to accept a small premium for the large risk to be hedged in the current environment.

The other options are too restrictive with regard to sales. You can start requesting buyers to put up letters of credit or pay cash in advance; however, these terms do not play well for the buyers' working capital because it ties up their availability. Unless you are willing to offer a deep discount, or you have something others don't, you will most likely lose the buyer to competitors.

The only true option available is to start managing credit risk more aggressively. Suppliers need to realize that credit risk is an important part of their business and start to set up procedures to deal with it on an on-going basis. Someone within the organization needs to be put in charge of managing credit risk and, most importantly, have access to the proper tools to do the job.

Available credit tools

The Internet has made information much more accessible to anyone with a computer and the time to go surfing. Unfortunately, unless you plan to hire a full-time credit manager dedicated to evaluating credit risk, you will not have the time to find the information you need to help with your credit decisions or to assess the implications of available information. You can start requesting copies of your buyer's financial statements but this could offend your customer because you have never asked for a copy in the past. Also, who will review the statements even if you were able to secure them? Credit reporting agencies offer various types of information and reports. The bigger problem here is that, until recently, reported information may have been limited and, more importantly, may have needed to be reviewed and analyzed. These types of reports are fine for a full-time credit manager that eats and sleeps credit, because these people have the time to evaluate the information. Unfortunately, for many scrap suppliers, these reports offer little or no value and have not been used.

Enter ProfitGuard, the first and only credit decision support program dedicated exclusively to the scrap recycling industry. The service was formed to deal with the growing level of credit risk within the scrap industry; it was felt that there was an increasing need for a service based on the rising level of default rates within the industry.

ProfitGuard

Global Commercial Credit / ProfitGuard has developed a proprietary credit decision modeling system that is exclusive to the scrap industry. A majority of the decisions are automated, helping remove the potential for human error and/or bias in the model. The company's mission is to help clients avoid losses while maximizing revenue opportunities through the use of up-to-date information and expert financial analysis. To accomplish this, it has structured a simple annual decision support subscription program giving clients access to a variety of specialized products in any required combination. This program is based on years of industry experience and credit risk management expertise, as well as state-of-the-art risk modeling software and a large database of detailed company information.

ProfitGuard provides its subscribers with a simple annual subscription program that gives them the ability to tailor the decision support services to their specific needs. The two main elements of the product line are:

> **Credit Limit Advisory Service**: providing a recommended credit limit on accounts submitted. The goal is to provide meaningful credit decisions in a timely manner by fax or e-mail, giving a good understanding of the credit risk behind a potential deal so you can make an informed business decision.
>
> **Alert Service**: providing up-to-the-minute news and relevant information on selected key accounts. Any credit deterioration information uncovered will be faxed or e-mailed as soon as it becomes available. This service can be especially helpful in monitoring accounts identified as significant short-term risks. ProfitGuard identifies which buyers they recommend to place on alert when the account is originally placed for a Credit Limit Advisory.

Conclusion

Without doubt, the economic and financial landscape of the scrap industry has changed and will continue to do so. In order to survive and prosper, a company needs to identify major risks and deal with them effectively. Credit risk will continue to dog the metals industry as the marketplace becomes more global. If you have not begun the search for possible solutions to the growing level of credit, we strongly recommend you do so before it is too late and you find yourself involved with a major buyer who finds himself unable to pay. Remember, a sale is not a sale until the cash is collected. Cash is oxygen to your business - you need to manage this resource effectively or you may be jeopardizing the long-term survival of your company.

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