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CREDIT RISK NEWSLETTER

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Europe's Energy Crisis Impacting the Metals Industry

Europe is currently undergoing an energy crisis that is expected to worsen during the upcoming winter. Manufacturing companies that rely heavily on natural gas have seen prices spike, forcing many to reduce capacity and gas consumption, or completely shut down. According to Eurometaux, a trade association representing the collective European non-ferrous metals industry, “50% of the EU’s aluminum and zinc capacity has been forced offline in the last twelve months, as well as 30% of silicon and ferro-alloys production and impacts across copper and nickel sectors." New closures or curtailments are announced every week. While some companies are adjusting run rates to avoid peak power pricing periods, there is still a fear that gas rationing will be necessary over winter months to ensure supplies aren’t depleted.

The energy crisis has the potential to do significant harm to European industry. As mentioned by the Financial Times, “While companies are digging in for a long winter, executives and politicians fear a wave of deindustrialization.” The soaring energy prices are reducing the competitiveness of Europe’s industrial energy consumers at an alarming rate. Temporary plant shutdowns can be costly and often impossible to implement without permanently damaging equipment. As a result, companies are looking to move production to regions where energy prices are more affordable. According to the International Energy Agency, European gas prices were on average two to three times higher from 2010 to 2020 when compared to the U.S. The gap is now as much as ten times wider since Russia began cutting back supplies.

Financial Times writes, “Experts warn that the longer companies are forced to shift production from Europe, the greater the risk that some output may never return."

The surge in energy prices and raw material costs will likely worsen European credit conditions. While gas prices have eased from recent highs, the cost is still around five times higher than in the U.S. Higher energy prices and slowing demand are negatively pressuring margins and overall credit metrics. High prices are also putting a strain on company competitiveness. Swedish Steel maker SSAB has already signaled that it will cut production in the fourth quarter as demand in Europe slows. Glencore is curtailing production at its Nordenham plant in Germany citing "various external factors affecting the business and wider European industry." Nyrstar placed its Netherlands smelter on care and maintenance a few months ago. ArcelorMittal announced it will close a blast furnace in Bremen, Germany, and a wire rod plant in Hamburg, Germany. These are just a few examples highlighting the effects of the energy crisis so far.

Analyzing Employee Stock Ownership Plans (ESOPs)

Employee Stock Ownership Plans (ESOPs) were created by Congress to provide a vehicle by which a company's employees could obtain an ownership stake in their employer through a Qualified Retirement Plan (QRP). As stated by the ESOP Association, “by establishing ESOPs and incentivizing their creation, Congress hoped to expand American workers’ equity ownership stake in American companies, which would allow workers to build wealth as their employers grow.” According to the U.S. Department of Labor, there are approximately 6,482 ESOPs in the United States, holding total assets of over $1.6 trillion. In this article, we will explain the different types of ESOPs and how they are accounted for.

The two types of ESOPs include non-leveraged and leveraged. A non-leveraged ESOP will periodically issue new stock from treasury or contribute cash to buy shares. Simply put, a non-leveraged ESOP will not borrow money/use debt to buy stock. When accounting for the non-leveraged ESOP, the company contributes cash or stock to the ESOP and will then record a compensation expense. Next, the shares will be distributed to the employee accounts within the ESOP, which creates a future repurchase obligation for the company to pay when an employee is able to collect. The future repurchase obligation will not be recorded on the balance sheet but will instead be contained in the financial statement footnotes.

Conversely, a leveraged ESOP will borrow money from a bank and use the loan proceeds to buy shares. As further explained by the ESOP Association, “if the ESOP is the borrower, the company guarantees the loan. As part of the guarantee, the company agrees that it will make contributions to the ESOP that will enable the ESOP to pay back the loan on schedule. If the borrower is the company—which is the arrangement preferred by many lenders—the company lends the funds from the loan to the ESOP so the ESOP can buy the shares.” If a loan is used, it

More Defaults on the Horizon

In the latest Credit Outlook survey from the International Association of Credit Portfolio Managers (IACPM), credit portfolio managers are forecasting rising defaults over the next year. 82% of respondents said corporate defaults will increase in North America, 77% said they will rise in Asia, more than 90% said they will rise in Europe, and 83% expect defaults to increase globally.

S&P Global also states “we can expect the number of defaults to continue to rise for the remainder of 2022 amid worsening credit conditions, which could erode margins and limit lower-rated companies’ ability to access funding.” The U.S. trailing-12-month speculative grade corporate default rate is expected to increase to 3.5% by June 2023, from 1.4% in June 2022. The leveraged loan default rate is also expected to rise to 2.0%, from 0.43% in July 2022.

Slowing growth and the impact on cash flows from higher interest rates and inflation are putting downward pressure on credit. It seems credit fundamentals have peaked, and we are now seeing downgrades outpacing upgrades.

EMPLOYEE STOCK OWNERSHIP PLAN

must be recorded as a liability on the balance sheet. Once this happens, a loan is created between the company and the ESOP and is recorded as a contra-equity account, which will have a negative impact on the company's equity position. It may even cause it to be negative. The contra-equity account will be reduced over time as the internal loan between the company and ESOP is repaid. Because of this, the company's risk ratios will be affected.

Understanding ESOPs and their impact on a company's financial statements is important for any credit manager. Be sure to read the footnote disclosures as they will provide an in-depth description of the plan, which will help you get a better understanding of the company's credit metrics.

Setting Customer Credit Limits in an Evolving Risk Environment

With a potentially weakening economic environment ahead, now is a great time to review your corporate risk appetite and adjust your risk tolerance when setting customer credit limits. As conditions change it is customary to adjust how liberal or restrictive you are with extending customer credit. Companies use different criteria such as profit margins, inventory levels, cash position, and other factors when establishing credit limits. Having a good balance and long-term plan to adjust is key to maximizing sales while managing an acceptable level of risk.

Including a process to set customer credit limits in your written credit policy is a best practice. Setting a limit in line with the customers corresponding risk profile will help minimize bad debt situations. High-risk customers should be restricted to lower credit lines because they have an increased chance of delinquent payments, defaulting on debt, or becoming bankrupt. Setting a limit can also encourage your customers to pay quicker. The limit can give you leverage over your customer and create a need for the customer to stay under their permitted credit limit to continue buying material. This can encourage quicker and more frequent payments to maintain the health of your business relationship and manage credit exposure.

Once you've established a credit limit for your customers, that doesn't mean the job is done. The term "set it and forget it" does not apply here. You should be monitoring the customer to make sure that the limit is appropriate throughout the duration of your relationship. Risk is fluid and needs to be monitored regularly. If you have the benefit of reviewing financial information on the customer and notice their results getting stronger and the company is growing, it may be an opportunity to increase the limit and improve credit terms to win more business. Conversely, if you notice a company's financial health deteriorating and payment behavior diminishes, it may be time to lower the credit limit and use restrictive terms to mitigate risk.

Setting a credit limit can be very subjective and there are many factors that make each case completely unique. It’s also important to be conscious of external conditions and adjust your credit-granting policy accordingly. Companies need to balance risk and reward when setting customer credit limits; establishing your risk appetite and tolerance while maintaining a credit limit framework will help ensure that your exposure levels are appropriate across your customer portfolio. This will minimize bad debt losses and help you remain competitive in today's rapidly changing marketplace.

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