JUNE | 2023

ProfitGuard
Know The Risk *Before* You Ship

CREDIT RISK NEWSLETTER

In this newsletter:

RISK RISING IN THE PRIVATE CREDIT SECTOR

Private credit helps companies raise debt capital by bypassing traditional banks and bond markets. Private credit managers seized the opportunity to enter the lending market during the pandemic, as regulatory changes altered the banking landscape. The private credit market expanded rapidly during the Fed's zero-interest rate era and now has close to $1.4 trillion in assets under management.

Private credit providers (also called non-bank or direct lenders) typically lend to companies that are either too small or too risky to use traditional bank lending, especially to private-equity-sponsored, middle-market companies. These providers can include private equity firms, hedge funds, insurance companies, or traditional asset managers. Household names include Apollo, KKR, and Blackstone to name a few.

Most direct lending deals carry floating interest rates, and with a 5% increase in the base interest rate over the space of just 18 months, borrowers are now feeling the strain of higher costs. This has led to deteriorating credit quality and mounting challenges for borrowers.

Another worrying private credit trend is the decline in borrowers' fixed-charge coverage ratios (FCCRs), which shows their ability to service their debt. Lincoln International, an investment banking company, said private companies are experiencing “notable and worrying” declines in FCCRs, showing many levered companies are struggling to pay interest.

According to Lincoln's proprietary private market database, when calculating the FCCR using a backward-looking 12-months of interest expense, the average FCCR dropped from 1.40x in Q1 2022 to just 1.26x in Q1 2023. This indicates that many businesses are basically living "paycheck to paycheck". If a company's FCCR is below 1x, it means its earnings can't cover its fixed expenses. With this declining ability to service debt, it's no wonder there has been an acceleration of covenant defaults.

While private credit is still an option for some businesses, we note the window could be closing, especially now that the private-equity (PE) market is slowing down. Middle-market borrowers with poor risk profiles may see their access to capital restricted. Investors continue to remain selective and focus on recession-resilient companies. Alternative asset lenders are targeting larger, more stable companies that include investment-grade businesses. As explained by Moody's, "Market uncertainty and higher interest rates are complicating PE's ability to exit existing investments and deploy capital into new leveraged buyouts (LBOs)."

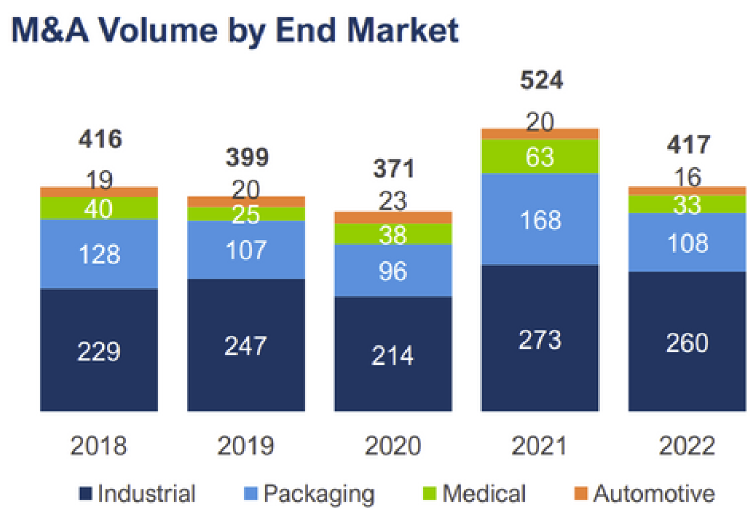
Higher borrowing costs, deteriorating operating performance, and limited access to capital will likely cause more defaults in the private credit sector for the remainder of the year. Moody's said private credit is facing its first serious challenge to its exceptional growth and said loans originated in 2021 would likely fare worst. Moody's has also gone as far as to predict that defaults are set to nearly double over the next year. The default forecast for the trailing twelve months from May 2023 is 3.07% and is forecast to be 5.64% by this time next year.

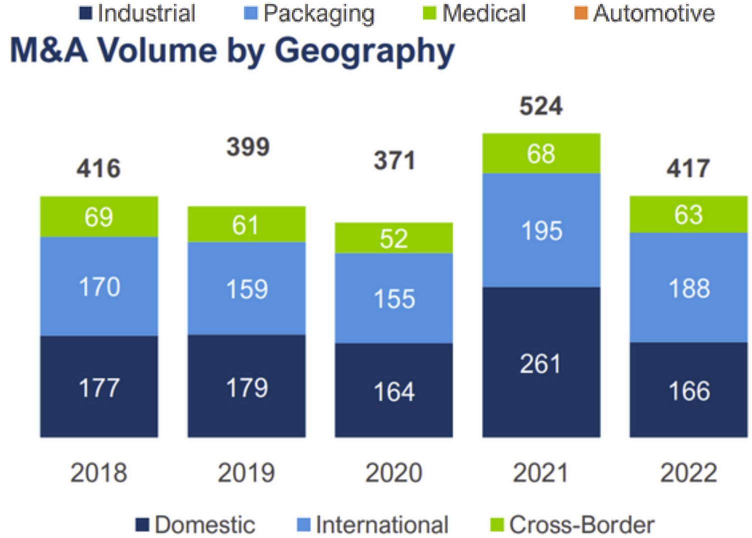
PLASTICS M&A OUTLOOK

After experiencing challenging market conditions in the second half of 2022, global plastics M&A activity year to date has been gaining momentum.

Stout's 2022 annual plastics industry update reported that "M&A activity within the medical, plastic packaging, automotive, and industrial end markets decreased 48%, 36%, 20%, and 5%, respectively, compared to 2021. Industrial end-market activity remained relatively strong in 2022 compared to material declines in other end markets. Within the industrial end market, blow molding, rotational molding, thermoforming, and plastics distribution were particularly bright spots."

"U.S. domestic M&A activity experienced a material slowdown during 2022, decreasing 36% compared to 2021. Cross-border and international M&A activity also decreased 7% and 4%, respectively. Within the U.S. market, plastics M&A activity saw the steepest declines in the automotive and medical end markets, as well as the injection molding and resin/compounding segments."





Source: Stout Plastics 2022 Annual Industry Update

Global plastics M&A recorded 35 deals in May according to PMCF, making it the most active month from a deal volume standpoint since March of last year. Overall, 2023 activity has been more stable in comparison to Q4 2022, and increasing volumes signify an improvement in the plastics M&A market. The Injection Molding subsector continues to experience high levels of deal volume in 2023, with activity through May of 2023 nearly matching the elevated levels seen in 2022.

We expect a meaningfully higher cost of capital to drag on the overall M&A market, but note financial buyers continue to hold record levels of dry powder and will likely focus on add-on investment opportunities. Private equity add-on transactions rebounded in May after a soft April by doubling last month's volume. Notably, this group of buyers posted their most active month since January of 2023 and continues to generate activity above historical levels.

EV MAKER LORDSTOWN MOTORS FILES FOR BANKRUPTCY

Lordstown Motors

On June 27, 2023, Lordstown Motors filed for Chapter 11 bankruptcy protection. The struggling electric-truck maker initiated the restructuring process to maximize the value of its assets: its on-the-road Endurance electric vehicle (EV) pickup truck. Let's look at two major risk items that played a role in Lordstown's bankruptcy filing.

Earlier this year Lordstown warned investors that bankruptcy was likely if it didn't reach an agreement with Foxconn or if it didn't acquire additional funding.

Contract disputes and Litigation

In September 2021, Lordstown began a partnership with an affiliate of Hon Hai Precision Industry Co., Ltd., also known as Foxconn ("Foxconn"), the world's largest electronics manufacturer. The purpose of the Foxconn partnership was to allow Lordstown to shift its business strategy from a vertically integrated OEM to a less capital-intensive model, focused on developing, engineering, testing, and industrializing EVs. Lordstown agreed to sell its factory to Foxconn for $230 million in exchange for financial and operational support for its truck production. However, Lordstown has accused Foxconn of fraudulent conduct and a series of broken promises in failing to abide by an agreement to invest up to $170 million, which caused material damage to Lordstown. As a result, Lordstown filed litigation against Foxconn to address Foxconn's alleged fraud, bad faith, and repeated contractual breaches.

Lordstown Motors was also embroiled with Karma Automotive (formally known as Fisker). Karma filed a lawsuit in 2020, suing Lordstown for $900 million alleging trade secrets theft. Karma alleges that as of 2019, Lordstown had yet to finalize a working vehicle for sale to the public, was under increasing scrutiny for its failure to do so, and became subject to an investigation by the Securities and Exchange Commission for misrepresentations about alleged “pre-orders” for its products. Discovery obtained by Karma in its court case demonstrated that Lordstown stole, among other things, Karma’s source code and subsequently incorporated it into Lordstown's infotainment system source code for the Endurance electric pickup truck.

Earlier this week, Karma filed an objection and told the bankruptcy judge that its 2020 lawsuit against Lordstown should be able to move forward. Despite being omitted from Lordstown's list of 30 Largest Creditors, Karma claims it is the largest creditor of Lordstown's estate by virtue of its damages claim in excess of $900 Million.

Cash burn and Going Concern

Lordstown was burning cash at an alarming rate, reporting $108.1 million at March 31, 2023, down from $629.8 million at December 31, 2020. This raised substantial doubt about the company’s ability to continue as a going concern. The company stated in its most recent 10-Q that its “ability to obtain additional financing is extremely limited under current market conditions, in particular for our industry, and also influenced by other factors including the significant amount of capital required, the Foxconn dispute, and the fact that the bill of materials (BOM) cost of the Endurance is currently, and expected to continue to be, substantially higher than our selling price.” The company’s depleted cash position also impacted its commercial production; Lordstown said in February that it had made only 31 units for sale and recalled 19 vehicles.

Lordstown is seeking Court approval for a timeline that enables an expedited marketing and sale process under section 363 of the Bankruptcy Code, with a sale hearing targeted for September 2023. Lordstown Motors’ largest unsecured creditor is Teijin Automotive Technologies Inc. of Auburn Hills, Michigan, which is owed $2.1 million. ZF Passive Safety Systems US Inc. of Washington, Michigan, is the second-largest creditor, owed $1.9 million, followed by Marelli North America Inc., a provider of driver technology based in Tennessee, owed $1.6 million.

While there were special circumstances that led to this bankruptcy, it is a reminder of the challenges EV makers face trying to design, manufacture, and sell a vehicle in a rapidly growing EV market.

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