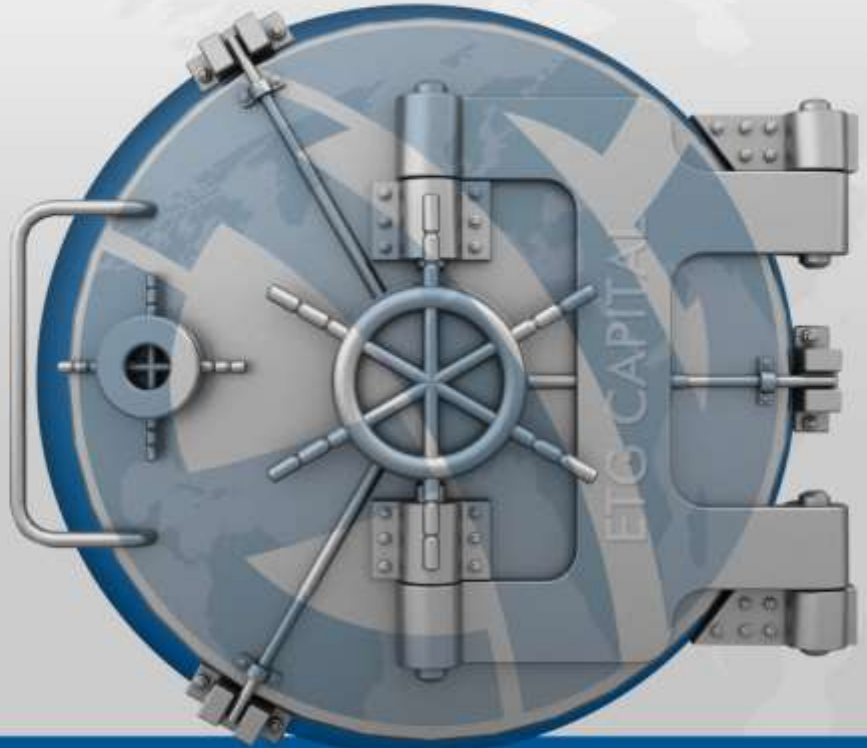
CREDIT RISK MANAGEMENT OPTIONS (ALTERNATIVES TO JUST SAYING "NO")



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ETG CAPITAL
VENDOR PROTECTION WHEN IT COUNTS

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Professional Background

- 6 years NY bankruptcy attorney
  - Skadden, Slate, Meagher & Flom and Davis Polk & Wardwell
  - Representation of debtors, lenders, vendors, bondholders in bankruptcy, insolvency, restructuring

- 5 years at Credit Suisse leveraged-finance
  - Created and managed receivables protection (put option) business.

- Since 2009, manages put option and non-cancelable, single-debtor insurance business, with a focus on protecting high-risk accounts receivable.

- Deep experience in automotive, building, chemicals, retail, consumer products, print/paper, plastics/packaging, metals, energy

NOT a credit manager, BUT a fixed-income portfolio manager; <u>AN INVESTOR</u>

- The proper way to look at receivables…..like a fixed-income investor (“$1 of product shipped is $1 loaned”)
  - *Difference*: relationship to the borrower

- **Always be thinking: “**What is a reasonable “return” on our investment”
  - Constantly changing risk profiles
  - While considering long-term relationship with customer

Risk/Reward Balance

- Achieving the appropriate risk/reward balance
  - Looking to the market for guidance- unsecured debt, comparables, etc.
    - **Example**: Feb. '09; Ford
      - Automotive-parts suppliers to ***Ford*** earning 2.5% net-profit per shipment (60 day terms; *effective yield of 15%).*
      - Ford debt yielding 20+%.
      - <u>Better investment to send all employees home and invest in Ford bonds!</u>

Risk/Reward Balance

- Which portfolio is better?

	Portfolio 1	Portfolio 2
Sales	$15mm	$20mm
Margin	12%	16%
Profit	$1.8mm	$3.2mm
Average Credit Spread	500bps	1200bps
Risk-adjusted Margin	7%	4%
Risk-adjusted profit	$1.05mm	$0.8mm
	WINNER	LOSER

High Risk- what to look for

- Don’t wait until days-payable (*i.e.* days receivable from your customer) starts to trend upward.
  - Said another way, “everyone pays- until they don’t”

  - Important Data Points
    - ***Leverage- covenants; as it relates to default and recovery
    - Cash-Flow- CapEx, interest expense
    - ***Liquidity- borrow, asset sales, other sources
    - Large important events (debt maturity, lawsuit, one-time capital expenditures)
    - Drastic CapEx cut-back, especially in retail and manufacturing

Tools to Use to Even the Risk/Reward Imbalance

1) Factoring

2) Whole-Turnover Trade Credit Insurance

3) Put Options

4) Credit Default Swaps

Polling Questions

Have you ever used factoring?

Have you ever used trade credit insurance?

Have you ever used a put option?

Have you ever used a credit default swap?

Factoring

Ideal Investor Profile:

1) Use the factoring services for **liquidity** (sale of receivables for working capital use; *i.e.* does not qualify for an asset-based loan); OR

2) Cannot afford the resources to perform *in-house* **credit analysis**

Details

- Legally, a sale of receivables
  - Recourse vs. Non-recourse
  - Advance (discount) vs. No Advance

- Factor may **modify or terminate coverage at any time**. The Factor is only as valuable as the last receivable purchased.

- **Caps** and **limits** for maximum exposure to particular companies.

- Normally, requires ***whole turnover*** (all accounts receivable) basis- in other words, supplier pays for coverage on accounts that are investment-grade.

Factoring

Details (cont'd)

- Principally, **Retail- and Consumer Goods-**focused.
- **Minimum receivables threshold amounts** for primary factors, otherwise re-factoring.
- Only protects **prospective (new) accounts receivable** incurred after the factoring services begin.
- Not available **in bankruptcy** (while Buyer is in bankruptcy).
- ***Surcharge*** or ***deductible*** added to high-risk accounts.

Players: CIT, Wells Fargo, Milberg, Capital Factors, Rosenthal & Rosenthal, IDB

Whole-Turnover Trade Credit Insurance

Ideal Investor Profile:

1) Use the insurance services for **catastrophic** risk protection; OR

2) Cannot afford the resources to perform *in-house* **credit analysis**; more ***cost efficient*** to outsource the services (*e.g.* monitoring 300,000 accounts)

Details

- Normally, requires ***whole turnover*** (all accounts receivable) basis- supplier pays for coverage on accounts that are investment-grade.
- Often, **cancelable** on notice, at the will of the insurer. It is a product for catastrophic risk.
- **Caps** and **limits** for maximum exposure to particular companies.
- Fees only for **actual sales**. Costly record-keeping and reporting.

Whole-Turnover Trade Credit Insurance

Details (cont'd)

- "Risk-attaching" (attaches to receivables) vs. "Loss-occurring" (event-driven)
- Limited to **annual** policies. Annual renewal could arbitrarily constrain clients to undesirable pricing.
- Not available in **bankruptcy**.
- **Deductible** costs must be considered.
- Costly customer ***credit status monitoring*** is required.
- Insurance is sold by sales brokers. It is purely a transaction-based solution.

Players: Euler Hermes, Coface, Atradius, QBE, Chartis (AIG)
Brokers: Marsh, Aon, specialty brokers

Put Options

Ideal Investor Profile:

1) Use to **supplement** factoring or trade credit insurance (*e.g.* credits not covered/dropped by factoring/insurance, seasonal spikes);

2) Experienced in-house credit team that doesn't use trade credit insurance or factoring and doesn't want to <u>lose profit</u> from sales to a **risky** customer (*e.g.* distressed, concentration, in-bankruptcy).

<u>Details</u>

- **Single accounts** only
- ***Non-cancelable/non-modifiable***
- *Varying* tenors (*e.g.* 6 months, 9 months)
- <u>Any industry</u>. Most public companies; on many private entities.

Put Options

<u>Details</u> (cont'd)

- *Effective immediately* on ALL outstanding accounts receivable to the customer (not just new receivables incurred after protection is purchased).
- Minimum amount (*e.g.* $1mm)
- Assumes a first-loss position; generally, there is **no deductible**.
- Only triggered upon a bankruptcy filing; <u>not</u> a failure to pay

Players: ETG Capital, JPMorganChase, Wells Fargo

Credit Default Swap

Ideal Investor Profile:

1) Use to eliminate credit risk from corporate debt, and focus on the interest-rate risk;

2) Speculate on credit risk on a directional basis.

Details

- **CDS** (Credit Default Swap) is a derivative that protects the principal value of a debt instrument
  - BUYER of CDS/Protection, SHORT credit (benefits from a drop/downgrade); Pays quarterly fixed-rate premium
  - SELLER of CDS, LONG Credit (benefits from a rise/upgrade); Receives premium, guarantees par value of debt
- Generally 5-Year Term; Other Liquid points are 1-yr, 3-yr, 7-yr, 10-yr; minimum is 1-yr
- “Rolls” every 3 months (Mar, Jun, Sep, Dec 20th)
- Fixed Rate, Quarterly Payments Paid Until Maturity or Credit Event
- Credit Event generally means a default/failure to pay or bankruptcy with respect to bonds

Credit Default Swap

Details (cont'd)

- Coverage on bonds and loans; NOT supplier's accounts receivable
- ISDA (Int'l Swaps and Derivatives Assoc.) agreement required; can take up to a month+ to negotiate
- Only available on certain publicly-traded companies; holding companies and not operating subsidiaries
- Available in $1MM increments
- Only available before bankruptcy
- Need to mark-to-market
- Settlement via a dutch-auction
- **Pricing**- "Credit Spread"- the spread between Treasuries and non-Treasury securities that are identical in all respects for quality rating; "Points Up Front" with "running" (100bps or 500bps)

Polling Questions

Are there any accounts that you currently consider high risk?

If so, are those accounts protected?

Pricing Methodology

Portfolio with cancelability (*i.e.* trade credit insurance and factoring)

Risk mitigants

(i) Weighted diversity (portfolio/algorithmic approach)

(ii) Cancelability (insurance- on notice; factoring- denial of next receivable)

Pricing is a function of:

(a) a blended score of companies/credits and limits *and*

(b) general economic environment

Pricing Methodology

Non-cancelable fundamental protection (*i.e.* put options and credit default swaps)

Considerations:

- Public vs. Private
  - Does the market have an opinion on the yield for the unsecured debt of the company?
  - If not (only secured debt and/or equity), what is a comparable company?
- Hedge available or not? Illiquidity discount (versus similar securities)
- Length of protection

Final Points

- Business-cards (contact information with industry focus) for related news alerts

- Presentations on a variety of topics concerning credit and financial markets, including, demonstration of fundamental analysis

- Call or email with questions

Summary

Distinguishing Factors and Considerations

- Liquidity vs. Risk Mitigation
- One-time vs. Cancelable vs. Non-cancelable
- Catastrophic/Portfolio vs. Fundamental/Single-Name
- Tenor Flexibility

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