Euler Hermes Americas

RISK MANAGEMENT UPDATE

After careful consideration, we have decided to reduce part of our portfolio that we consider high risk in response to a significant increase in claims activity and to mitigate against future defaults. Our rationale is summarized below and is specific to industry sectors.

In 2019, we saw a lot of disruption and declining performance from smaller and weaker players. Our internal analysis indicates that both the number of claims and dollar volume amounts have risen at a significantly higher rate than we have seen before. The outlook for 2020 will be even more challenging with the coming recession.

AGRIFOOD

In 2019, we saw a lot of slow pay claims, as well as high profile bankruptcies. In 2020, commodity prices have been mixed and oversupply remains a concern. Labor shortages and supply chain disruptions remain a threat and have forced some companies to search for liquidity solutions that are increasingly difficult to manage. Our internal analysis indicates that both the number of claims and dollar volume amounts have risen at a significantly higher rate than we have seen before. The outlook for 2020 is negative.

EXTERNAL OBSERVATIONS

- Tariffs imposed throughout 2019 caused a great deal of uncertainty for domestic food growers, who at least temporarily lost access to some foreign markets where they typically export goods.
- An oversupply of agricultural commodities, such as milk and various grains, caused suppressed prices and difficulty running profitable operations that covered production costs.
- Uncertainties in the current environment have caused meat and seafood prices to decline in the midst of lower demand from restaurants and entertainment venues.

INTERNAL OBSERVATIONS

- Total filed number of claims in this industry has increased 37% from 2018 to 2019.
- Total dollar amount of claims in this industry has more than doubled from 2018 to 2019.
- Past due filings, which are a leading indicator of future defaults, have steadily risen in Agrifood companies throughout 2019.

METALS – BLAST FURNACE

Following the implementation of tariff on steel imports, U.S. mills restarted idled mills and stepped up production capacity in 2018. In 2019, the domestic market has since cooled and prices have moved substantially lower due to weak global supply-demand conditions, inventory destocking and increased local supply. We saw declining performance and weakness in this sector characterized by increasing claims activity. Our internal analysis indicates that both the number of Claims and dollar volume amounts have risen at a significantly higher rate than we have seen before. The outlook for 2020 remains concerning.

EXTERNAL OBSERVATIONS

- Increased local supply and lower demand have pushed prices substantially lower in 2019.
- In addition, scrap steel prices fell to three-year lows due to lack of export demand, putting additional pressure on pricing in the steel supply chain.
- The reduced demand in end markets as a result of overall economic slowdown is putting pressure on profit margins across the sector
- Despite some mill outages, average US mill utilization rates rose to around 82% through February 2020.
- The short term outlook for this sector is bearish and will be characterized by weak demand and falling prices.

INTERNAL OBSERVATIONS

- Total filed number of claims in this industry has increased 73% from 2018 to 2019.
- Total dollar amount filed in 2019 increased 196% from 2018.
- We continue to see an uptick in number of claims filed as well as total amount filed. January 2020 shows a 150% increase in volume along with a 228% increase in amount filed compared to prior year.

METALS – STEEL SERVICE CENTERS

The section 232 tariffs imposed in 2018 provided a boost to steel prices and output from domestic steel producers increased due to the curb of imported steel. The price increase was short lived as the increase in domestic capacity resulted in a supply glut. During 2019, steel service centers had shown signs of distress as they faced a sharp decline in prices. Our internal analysis indicates that dollar volume amounts have risen significantly. The outlook for 2020 remains concerning.

EXTERNAL OBSERVATIONS

- Excess domestic steel supply due to increased production output has caused steel prices to decline from peak 2018 levels. Domestic hot rolled and cold rolled coil average prices declined 27% and 20%, respectively, in 2019 from 2018.
- The decline in prices along with reduced demand volume from end markets continues to negatively impact the revenue and profits of steel service centers.
- Demand from end-use markets such as automotive and energy is hurting steel consumption. In 2019, U.S light vehicle production declined 3.4% from the prior year to approximately 10.6 million units. The oil and gas industry also experienced reduced activity in 2019 and is expected to struggle in 2020 with oil prices down more than 50% since the beginning of 2020.
- Inventory markdowns and margin compression is causing liquidity constraint on service centers that have less flexible balance sheet.

INTERNAL OBSERVATIONS

- In 2019, filed number of claims in this industry were relatively flat compared to 2018.
- Total dollar amount of claims filed showed a 67% increase from 2018 to 2019, indicating a drastic increase in average claim size.
- The overall number of claims within the sector remains high with an 18% increase in dollar amount filed within the first month of 2020.

OIL & GAS

WTI prices on average decreased to $56.98/Bbl in 2019 from $65.23/Bbl in 2018. The reduced activity associated with the decline in oil price has caused substantial impact throughout the industry. WTI prices continue to decline in 2020 and most players in the industry are vulnerable in a sustained low price environment. Our internal analysis indicates that both the number of Claims and dollar volume amounts have risen at a significantly higher rate than we have seen before. The outlook for 2020 is negative.

EXTERNAL OBSERVATIONS

- The rig count in the U.S decreased 9% in 2019 compared to 2018, as a result of lower commodity prices and exploration and production capital expenditure reductions. Despite a decline in rig counts, oil production output in the US increased 11% during 2019 causing a supply glut which impacted the profitability of many firms.
- On March 6th, Saudi Arabia and Russia have initiated a price war and announced they would boost production starting April 1st, driving Brent and WTI prices below $30/Bbl.
- With current oil prices well below break-even price point, potentially for a prolonged period, producers will face challenges to maintain sufficient profitability.
- As a result of reduced prices, US producers have already announced significant cut in capital expenditures. This will have an immediate impact on the oilfield services companies that will face a sharp reduction in the level of activity.

INTERNAL OBSERVATIONS

- Total filed number of claims in this industry has increased 138% from 2018 to 2019.
- Total dollar amount of claims in this industry has increased 737% from 2018 to 2019.
- Past due filings, which are a leading indicator of future defaults, have steadily risen in this sector throughout 2019.

RETAIL

2019 was a very challenging year for Retailers characterized by significant increases in both the number and dollar amount of claims. Retailers continued to struggle trying to adapt their strategies to meet rapidly evolving market conditions. In 2020, major disruptions are underway with mass closings, strained supplies and shifting demand. With our current environment, many more retailers are at risk with a negative outlook for 2020.

EXTERNAL OBSERVATIONS

- Consumer behavior continues to shift, especially with discretionary spending, as traditional retailers have struggled to evolve to these rapid changes.
- The current environment has exacerbated an already fragile dynamic for many brick and mortar retailers which will continue to suffer severe traffic declines.
- Prolonged store closures will drag down even the more stable retailers.
- Liquidity strained retailers continue to find themselves in a difficult lending market and often lack adequate capital protection measures.
- Generally, market share has been eaten by a relatively small contingent of mass merchandisers and online disrupters, with much less share left behind for everyone else.

INTERNAL OBSERVATIONS

- Total number of claims in this industry has increased 23% from 2018 to 2019.
- Total dollar amount of claims in this industry has increased over 61% from 2018 to 2019.
- Past due filings, which are a leading indicator of future defaults, have steadily risen in Retail companies throughout 2019.

SERVICES

The services sector accounts for more than two-thirds of economic activity in the US, and the state of our economy plays a direct role in consumer and business spending. With governments closing off their borders and issuing "shelter-in-place" and "social distancing" orders, the industry is expected to faces severe headwinds for the remainder of 2020. Our internal analysis indicates that both the number of claims and dollar volume amounts have risen at a significantly higher rate than we have seen before. The outlook for 2020 remains concerning.

EXTERNAL OBSERVATIONS

- US Consumer sentiment has been declining since mid-2019, partly due to trade disputes and tariffs. The economic impact of these trade policies have started to impact sentiment and the service sector.
- We anticipate reductions in discretionary consumer spending this year. The sector is particularly sensitive to reductions in discretionary consumer spending, and a weakening economy will lead to further declines in consumer demand. We anticipate demand to remain very weak, at least through the first half of 2020.
- Labor shortages have made it more difficult for companies in this sector to source and hire workers. This has had a direct impact on the overall labor costs, and revenues impacting profitability.
- In order to meet shifting consumer demand, stay competitive and improve the overall customer experience, companies need to continually invest in technology. This has placed greater pressure on smaller and weaker companies.

INTERNAL OBSERVATIONS

- Total number of claims filed in this Sector have increased by 39% from 2018 to 2019.
- Total claims filed in dollar amount, have increased over 141% from 2018 to 2019.
- The Service sector, while accounting for a smaller overall portion of exposure for EH, demonstrates a disproportionate amount of claims demonstrating clear weaknesses within the sector.

TEXTILES

In 2019, there was significant disruption and declining performance from smaller and weaker players within the Textiles sector. Our internal analysis indicates that both the number of claims and dollar amounts have risen at a significantly higher rate than we have seen before. In 2020, we anticipate continued challenges resulting from substantial demand shifts and liquidity concerns among the weakest Textile companies. The outlook for 2020 is negative.

EXTERNAL OBSERVATIONS

- Throughout 2019 and into 2020 various Supply Chain Disruptions, such as tariffs and factory shutdowns have impeded results and dragged down revenue and margins.
- Changing consumer demands and ways of shopping are continuing to pressure smaller and weaker companies with more discretionary inventory.
- In recent years, in response to this pressure, companies have had to invest in innovation and process improvement to fight margin compression and stay profitable—which has led to higher debt levels and weaker Balance Sheets.
- The negative outlook for 2020 will continue at least through the near term.

INTERNAL OBSERVATIONS

- Total filed number of claims in this industry has increased 82% from 2018 to 2019.
- Total dollar amount of claims in this industry has increased over 300% from 2018 to 2019.

TRANSPORTATION – MOTOR FREIGHT

Excess capacity in 2019, which followed a strong period of capital investment in the years prior, resulted in a sharp drop in spot prices throughout the industry. This forced many motor freight companies into bankruptcy. Prices were expected to remain somewhat depressed in the early parts of 2020, with a recovery beginning to show life in H2. However, supply chain disruptions in China caused a drop in imports from that country, while an overall uncertain economic climate has raised doubts on demand for shipments matching the excess capacity in the industry.

EXTERNAL OBSERVATIONS

- The Port of Los Angeles, which had more than $275 billion worth of goods flow through it in 2019, reported a 23% decline in cargo volumes in February and 25%, or 41 vessels, have cancelled from mid-February through April 1, 2020.
- This decline in container volume will adversely impact freight trucking volume, driving down prices in a sector that saw soft spot pricing in 2019 due to excess capacity.
- Short-haul, refrigerated volume has been the lone bright spot in the sector as grocers have had to restock their shelves due to the unprecedented spike in grocery store sales volumes.
- However, non-grocery retailers have shut down stores and cut hours as Federal, State, and Local governments have pushed for social distancing and even issued "shelter-in-place" orders, which have essentially locked down cities from non-essential commerce. This will result in fewer goods requiring replenishment, and ultimately, fewer deliveries for transportation companies.
- Original Equipment Manufacturers are braced for a soft 2020, with industry backlog down 123K orders at 12/31/19 compared to 297K orders at the end of 12/31/18.
- Cummins, Inc. is forecasting a 40% decline in production of Heavy Duty trucks in 2020, 20% decline in medium duty trucks, and 10% in lightweight trucks.

INTERNAL OBSERVATIONS

- Total filed number of claims in this industry has increased 31% from 2018 to 2019.
- Total dollar amount of claims in this industry has increased over 44% from 2018 to 2019.

TRANSPORTATION – AUTO PARTS SUPPLIERS/TIRES

Auto suppliers are facing challenges with several major auto manufacturers shutting down production due to public health concerns, while supply chain disruptions in China had already forced major manufacturers to seek alternative suppliers to meet their production targets. Tire distributors and service stations had shown signs of distress as the number of claims and the amount of claims filed increased sharply in 2019. The supply disruptions, along with the demand challenges, make 2020 a more challenging year for the industry.

EXTERNAL OBSERVATIONS

- Ford, GM, and Fiat Chrysler have all temporarily closed US factories.
- Prior to the shutdown, major manufacturers such as GM and Fiat Chrysler identified parts shortages and were seeking alternative suppliers.
- Tire manufacturers are facing challenges in China with moving raw materials to factories from ports, and finished goods back to ports; Approximately 17% of truck tires sold in the US in 2019 were imported from China.
- Tire container volumes coming out of China have dropped 40%, causing potential shortages, and posing challenges for smaller players to get necessary inventory in stock.

INTERNAL OBSERVATIONS

- Total filed number of claims in this industry has increased 34% from 2018 to 2019.
- Total dollar amount of claims in this industry has increased over 75% from 2018 to 2019.
- Suppliers focused on tires accounted for 69% of the total claims in this sector, representing a 64% increase over 2018.