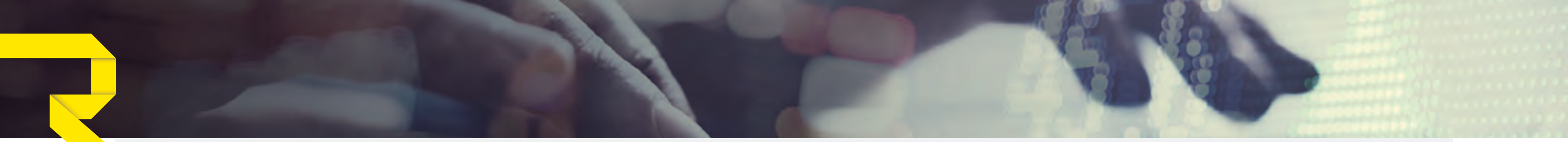
RAPIDRATINGS®

RapidRatings 2019 Annual Default Review

Supply Chain Risk Edition



Executive Summary

Supply Chain Optimized: Diagnosing Supplier Deterioration & Uncovering Competitive Advantage

Supply chain risk management is a vastly different discipline today than it was as few as five years ago. Technology has transformed what it means to be lean, while globalization has brought the world closer together. The modern supply chain is comprised of integrated systems, data, processes and people, creating complex interdependencies outside traditional company boundaries. The result, in theory, is greater speed and efficiency, and ultimately, more value to the end-customer. In practice, however, the connected supply chain is only as strong as its weakest link. Any supplier failure—whether due to a labor dispute, natural disaster, or credit default—can have financial, operational and reputational repercussions up and down the supply chain. Alternatively, resilient supply chains built with the strongest partners can flip the narrative and not only combat disruption, but also uncover opportunities.

The financial health of suppliers is no less critical to a healthy supply chain than other Key Performance Indicators (KPI's) such as quality, capacity or on-time delivery. What's more, financial deterioration, whether it leads to eventual default or not, raises the likelihood of deterioration in those other KPIs. For instance, companies that fall into RapidRatings' High Risk category are twice as likely to deliver low quality or faulty goods, and nearly three times as likely to deliver late. Transparency into both public and private company financial performance is therefore essential to supplier due diligence in both procurement and ongoing supplier risk management. Monitoring supplier risk indicators can help supply chain management professionals avoid unplanned downtime by assessing vendor criticality and adjusting sourcing strategies—before a disruption occurs.

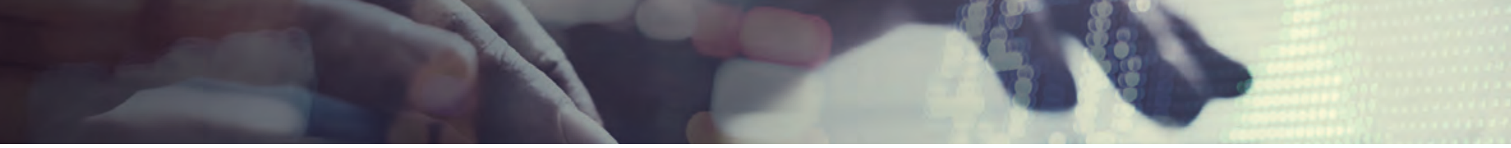
Against a backdrop of 284 industrial firms that defaulted or filed for bankruptcy between 2014 and 2018, RapidRatings' 2019 Annual Default Study explores trends among the 2018 default cohort, which encompasses 37 non-financial public companies in the United States.*

By reviewing defaults in aggregate and over time, we can identify the signals of future supplier distress and broader indicators of economic and financial risk.

*For this study, the term default is defined as a missed interest payment on public debt or bankruptcy filing in a U.S. Bankruptcy Court.

Supplier Weakness Business Impacts:

- Loss of revenue and increased costs
- Loss of customers or business partners
- Reputational damage
- Late deliveries
- Declining quality
- Inventory misalignment
- Production slowdown or shutdown
- Higher insurance premiums



By the Numbers: Recession Trends & Supplier Defaults Predicted

The RapidRatings FHR® is an analytic measured numerically on a 0-100 scale representing the financial viability of a company, where companies with low ratings have a higher probability of default. Of the firms that defaulted in 2018, 95% had a "high risk" or "very high risk" FHR. At the same time, only 23% of the total population was classified as high or very high risk, indicating accuracy with a low false alarm rate.

The study found that supplier deterioration can be accurately predicted as far as 3 years in advance, based on an assessment of the company's overall financial health. Moreover, 2018 defaulters are showing signs of deterioration earlier than 2017 defaulters, indicating companies are able to survive for a longer period of time in a weakened state, primarily because they can easily refinance to remain afloat.

2018 Defaulters by the Numbers

95

The percentage of defaulters that filed for bankruptcy while rated High or Very High Risk (FHR below 40).

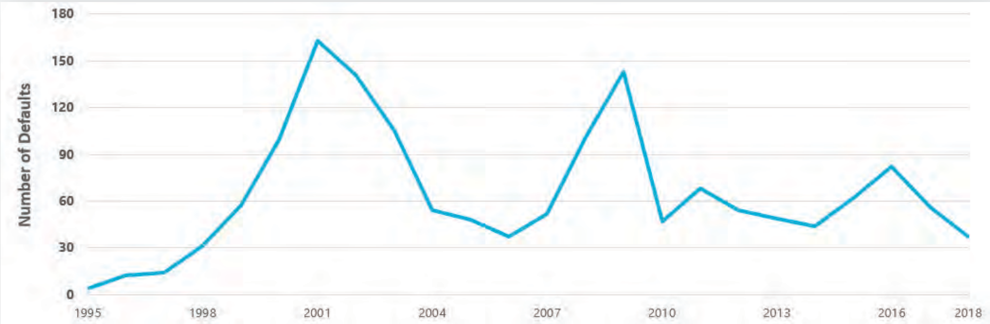
26 & 35

The average FHRs 12 and 36 months prior to default

25

The average FHR of companies at the time of default, on a scale of 0-100.

Default Frequencies Over the Past Three Decades

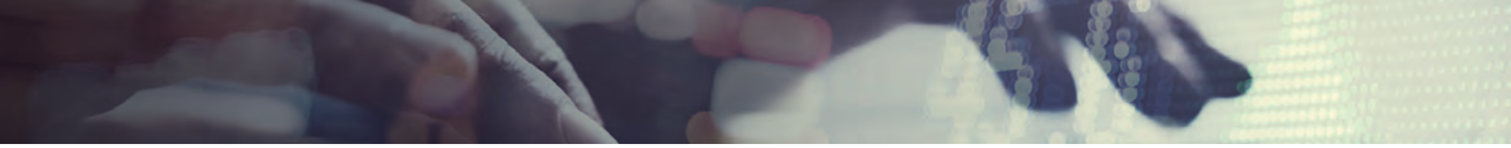


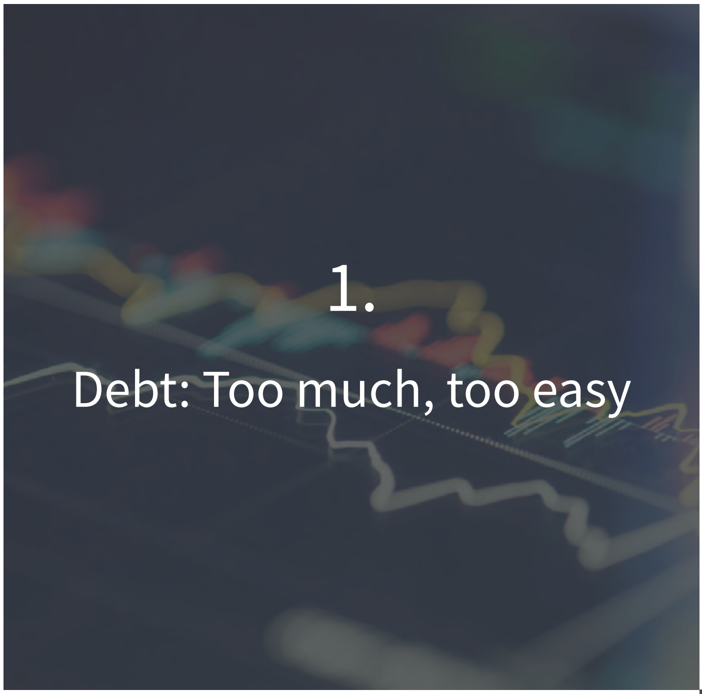
While total number of industrial defaults is at a five-year low, according to this year's RapidRatings Annual Default Review of US non-financial public companies, **the same was also true on the eve of the previous two recessions. When the tide turned towards the Financial Crisis, defaults increased by 60%, and then 171% in 2008 and 2009, respectively.** With murmurs of a recession on the horizon, and the costs of supplier failure become increasingly pervasive, don't let low default rates today give a false sense of security.

Supply Chain Red Flags

The Bottom Line:

Companies have had easy access to debt. Overleveraged or not, in more difficult times, suppliers will face financial and operational challenges/dire consequences. A company with high debt, cash flow pressure, and refinancing risk, will have a difficult time surviving market volatility.

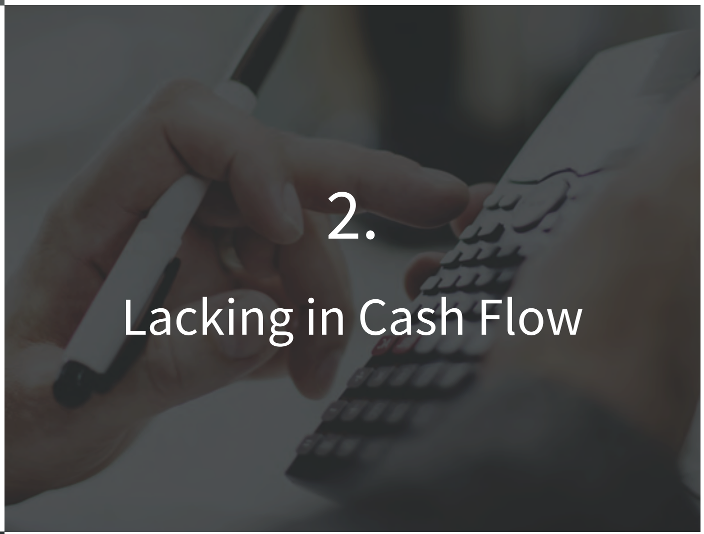




1. Debt: Too much, too easy

Watch out for outsized debt burdens, which quickly can lead to bigger operational issues. For the better part of the last decade, weaker companies have had easy access to capital. Compared to non-defaulters, 2018 defaulters had an average of 3x the amount of leverage (86% vs. 26%), a higher cost of debt (9% vs. 4%), and a lower capacity to pay (interest coverage of -1.7x vs. +2.8x). In the event of a down market cycle, companies with weakening FHRs are less able to service their debt, flagging potential issues in their ability to deliver quality products and services on time.

Average FHR 12 months prior to default: **26** in 2018 vs **33** in 2017
Average FHR 36 months prior to default: **35** in 2018 vs **42** in 2017



2. Lacking in Cash Flow

In both 2017 and 2018, defaulters generally maintained cash levels that were less than 15% of their current liabilities. Likewise, Cash From Operations (CFO) to Current Liabilities was negative for defaulters in the past two years. Positive CFO is critical to sustainability. By contrast, the average cash ratio at the beginning of 2018 was 40% for overall US coverage.

3. Deteriorating Profitability

Profitability characteristics of 2018 defaulters were materially worse than that of 2017 defaulters. Median Return on Assets (ROA), for example, worsened from -17% in 2017 to -33% in 2018. Be wary of suppliers that seek to be all things to all people. If they're not concentrating efforts to efficiently use their assets to generate revenues, profits, and cash flow, consider alternative suppliers with more efficient business models.

4.

Increasing Vulnerability to Market Influences

For the past 5 years, the energy sector has seen the most defaults of any industry and retail defaults are on the rise despite healthy consumer spending. In 2018, energy and water companies represented 27% of defaults. Fluctuating commodities pricing, global politics, environmental concerns, and regulatory issues present significant complexity and uncertainty compared to other industries.

5.

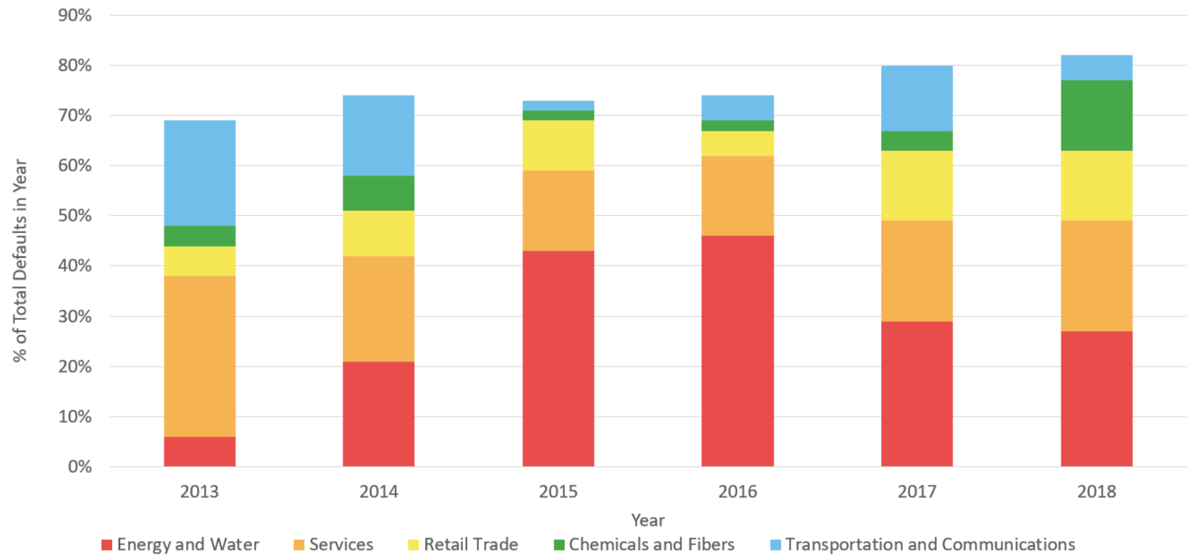
Weakening FHRs

The typical profile of a defaulter makes it easier to spot weak links in a supply chain. According to this year's study, 95% of defaulters failed while rated High or Very High Risk, on par with 2017. In many cases, weakening financial health was identified in excess of 12 months before the default occurred, providing an early indicator of other aforementioned costly supplier issues. Still, the average FHR prior to default has steadily decreased over the past five years, with a significant decline in 2018 compared to 2017. The ability for weak companies to stay afloat for longer makes it all the more critical to pick out the time bomb amongst weak FHRs.

Companies that fall into RapidRatings' high risk category are twice as likely to deliver low quality or faulty goods, and nearly three times as likely to deliver late.

Meanwhile, retail saw a surge of defaults between 2016 and 2017 (5% vs 14%) and that number held steady in 2018 (14%). Rationalizing brick-and-mortar investments and an inability to reduce debt are major factors. Looking forward, as trade war tariffs negatively impact international import/export businesses, a continued rise in retail defaults can be expected.

Top 5 Industries with the Most Defaults



Strengthening Supply Chain Value: An Ounce of Prevention is Worth a Pound of Cure

Supply chain risk has reached an inflection point. Businesses today are operating in a networked ecosystem where suppliers and customers are more interconnected than ever. Ultimately, the value businesses generate no longer sits within their own four walls but extends to their furthest supplier and on through to the customer. The more interoperability that exists within the supply chain, the more companies and their supply chains end up co-creating the value they generate for customers. As a result, the financial risk that exists within an entire supply chain ecosystem poses a direct threat to a company’s bottom line.

With a potential recession looming and tariffs upending traditional trade flows, proactively monitoring the financial health of your supply chain ecosystem enables you to identify early warning signs, build supply chain resilience, and avoid loss of revenue or reputational damage. At the same time, in extending the emphasis on value creation to risk management practices, supply chain professionals can not only mitigate financial risks, but also uncover financial strengths that give way to greater opportunities with suppliers.

Learn more here about how the RapidRatings’ Financial Health System can help you avoid a supply chain interruption.