Credit Case-in-Point

Company: Smithy Glass and Ceramic, Inc. (SGC)

SGC, Inc.

200-year-old manufacturer and seller of glass and ceramics based in US, with operations in Europe, Mexico and China

The company owns manufacturing facilities in several countries and also sources manufactured products to compliment its own lines

Largest glass tableware manufacturing, distribution and service network in the Western Hemisphere and among largest in the world with retail and wholesale customers in over 100 countries

Sells under its own branded line as well as other brand names primarily in the foodservice, retail, e-commerce and business-to-business channels

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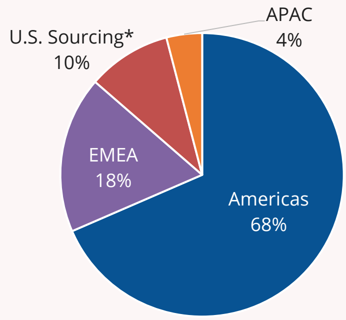
Summary Operating Data for SGC

	Year -4	Year -3	Year -2	Year -1	Year 0
Net Sales	748.6	799.7	819.5	828.5	822.2
Sales growth		6.8%	2.5%	1.1%	(0.8%)
Gross profit	133.1	168.0	168.7	195.2	187.3
Gross margin	17.8%	21.0%	20.6%	23.6%	22.8%
Operating Profit	36.6	126.8	63.5	81.3	70.9
Operating Margin	4.9%	15.9%	7.7%	9.8%	8.6%
EBITDA	97.1	99.9	105.4	122.8	139.9
EBITDA margin	12.3%	12.5%	12.9%	14.8%	17.0%
Total debt			466.5	466.5	473.0
Total debt/EBITDA			3.8x	3.4 x	3.5x
EBITDA/interest			3.3x	4.4 x	4.8 x

Sales by Geography



*US Sourcing refers to merchandise sold but no produced by SGC

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Timeline of Financing Events

- **T-8 YRS**: Issued $400mm Senior Secured Notes @ 10%
- **T-5 YRS**: Secured new $110mm ABL revolver
- **T-4 YRS**: Revolver amended to $100mm
- **T-2 YRS**: Refinanced $400mm Notes with $450mm Senior Notes @ 6.875%*
- **T-1 YRS**: Redeemed $45 mm of Notes
- **TODAY**: Seeking to refinance remaining notes with cheaper capital

* These are redeemable by SGC for the next three years, up to 35% at 106.875 from new equity or up to 10% at 103 in any 12-month period (plus accrued interest). After those three years, they are redeemable at predefined prices

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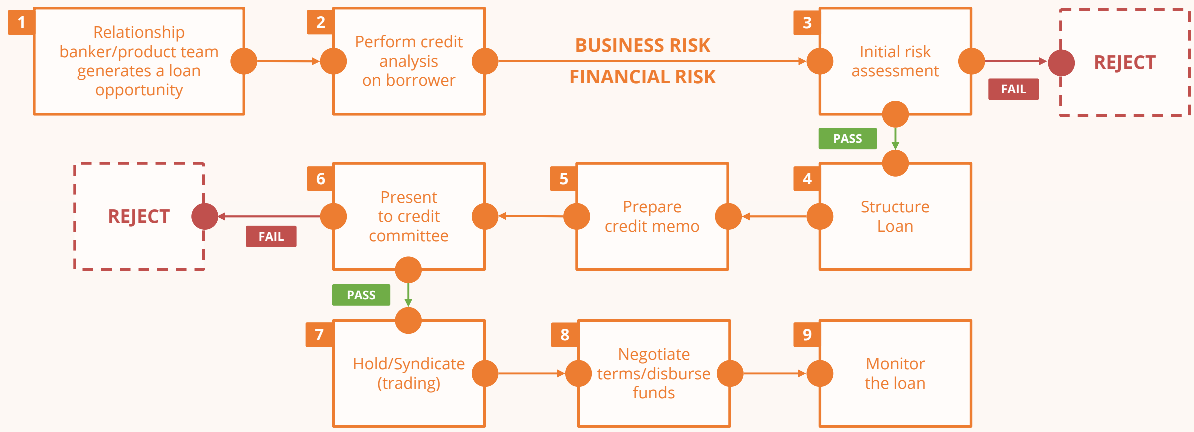
Does the Bank Want to Be in this Credit?

THE BANK IS CONSIDERING MAKING A LOAN TO REFINANCE THE NOTES



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Credit Risk Components of SGC

Business Risk

COMPANY
- Size, market share, product depth, innovation

INDUSTRY
- Strong, steady, or in decline
- Many competitors?

COUNTRY
- Operations abroad?

MANAGEMENT
- Track record or a plan

Financial Risk

FINANCIAL POSITION
- Balance sheet and off-balance sheet

QUALITY OF EARNINGS
- What is happening with sales and margins?

CASH FLOW

LIQUIDITY
- Access to cash?

Debt Capacity

HOW MUCH DO THEY NEED?

HOW MUCH CAN THEY BORROW?

WHAT SHOULD THE STRUCTURE BE?

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Assessing Business Risk
SIZE
Very few investment grade companies < $1bn, especially consumer durables
Narrow product focus, Not much innovation
Expensive labor
Fierce competition and increasing substitutions
Strong global presence. Future growth driven by Asia, where SGC is small
Capital Intensive
Market leader, well recognized brands
Management playing it safe (focused on margins instead of growth)
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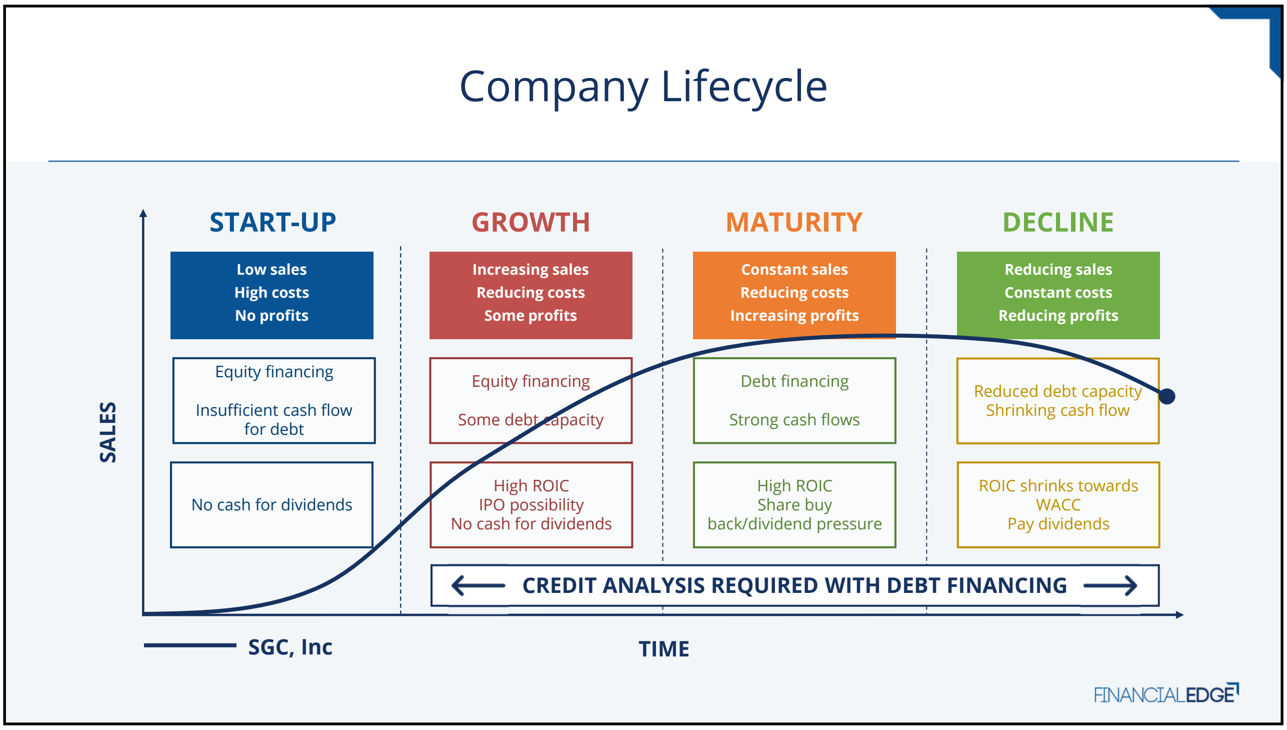
Company Lifecycle
SALES
START-UP
Low sales
High costs
No profits
Equity financing
Insufficient cash flow for debt
No cash for dividends
GROWTH
Increasing sales
Reducing costs
Some profits
Equity financing
Some debt capacity
High ROIC
IPO possibility
No cash for dividends
MATURITY
Constant sales
Reducing costs
Increasing profits
Debt financing
Strong cash flows
High ROIC
Share buy back/dividend pressure
DECLINE
Reducing sales
Constant costs
Reducing profits
Reduced debt capacity
Shrinking cash flow
ROIC shrinks towards WACC
Pay dividends
CREDIT ANALYSIS REQUIRED WITH DEBT FINANCING
SGC, Inc
TIME
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SGC Business Risk Analysis

	NO RISK	LOW RISK	INTERMEDIATE RISK	SIGNIFICANT RISK
Company				☑
Industry			☑	
Country		☑		
Management		☑		
Overall			☑	

Financial Risk Analysis

BALANCE SHEET

1. Debt and debt like instruments, on- and off-balance sheet
2. Working Capital
3. Fixed assets (not an issue for SGC, but clearly asset intensive)

EARNINGS | **CASH FLOW** | **LIQUIDITY**

Debt and Other Obligations

	Year 0
ST Debt	6.9
Long term debt	405.0
Operating leases	61.1
Unfunded pension	0.0
Total adjusted debt	**473.0**

Debt/Equity	361.6%
Debt to Capital	71.3%

Balance Sheet Debt

Additional debt-like obligations (pensions, leases)

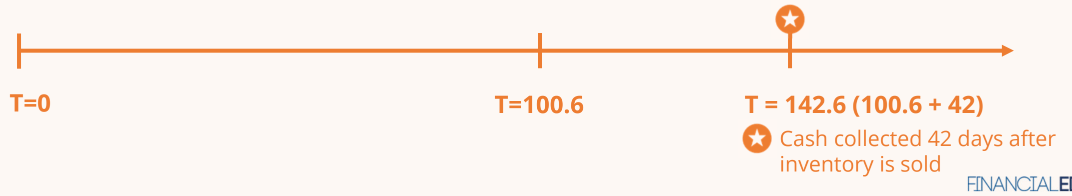
Also, any off-balance sheet obligations such as guarantees (none in this case)

Working Capital - Inventory

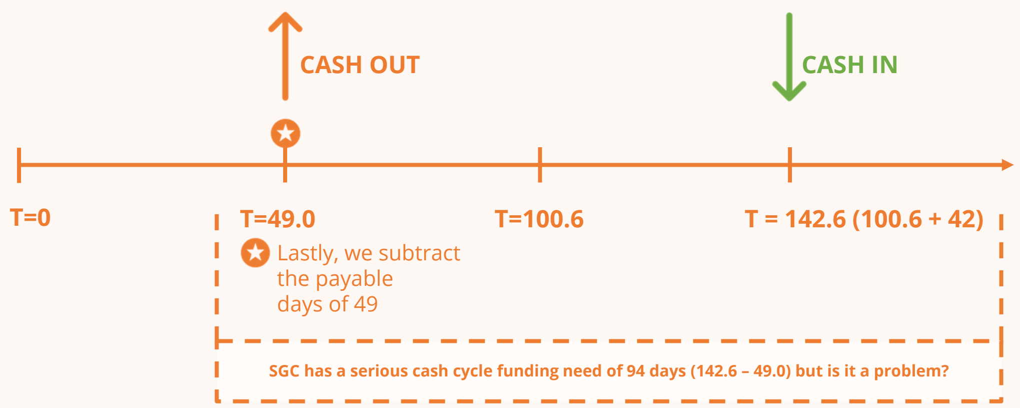
Inventory	**Year 0**
Total inventory	100.0%
Obsolete inventory	3.9%
Promotional inventory	4.7%
Work in process/raw materials	12.0%
Sellable finished goods	**79.4%**
Inventory Days on Hand	**100.6**

Working Capital – Accounts Receivable

Accounts Receivable	Year 0
0 to 30 days	51.3%
31 to 60 days	10.2%
61 to 90 days	6.9%
Greater than 90 days	32.6%
Total Days Outstanding	**42.0**



Working Capital – Cash Cycle



Sales, Margins, and EBITDA

	Year -4	Year -3	Year -2	Year -1	Year 0	
Net Sales	748.6	799.7	819.5	828.5	822.2	1
Sales growth		6.8%	2.5%	1.1%	(0.8%)	
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Gross margin	17.8%	21.0%	20.6%	23.6%	22.8%	2
Operating Profit	36.6	126.8	63.5	81.3	70.9	
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EBITDA	97.1	120.9	105.4	122.8	139.9	
EBITDA margin	13.0%	15.1%	12.9%	14.8%	17.0%	3
Total debt				466.5	411.9	
Total debt/EBITDA				3.7 x	3.4x	4
EBITDA/interest				2.2 x	2.6 x	

1 **Growth slowing (decline) the past 3 years**

2 **Margins have held steady**

3 **EBITDA consistent**

4 **Ratios indicate why SGC has been able to refinance until now**

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EBITDA Calculation

	Year 1	
Revenues	822.2	
Cost of sales	592.0	
Depreciation	43.8	
Gross profit	186.4	
Selling, general, & admin.	115.1	
Amortization	1.2	
Non-recurring expenses (income)	8.0	1
Operating income	62.1	
Add: Non-recurring expense	8.0	
Add: Lease payment	18.6	2
Add: Depreciation and Amortization	45.0	
EBITDA	133.7	3

1 **Add back restructuring expenses**

2 **Since we are including the operating lease liabilities, we need to add back the lease expense**

3 **No pension adjustments are needed. The pension plan is funded and non-pension obligations are not considered debt-like.**

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Financial Risk – Cash Flow Metrics*

	Year 1
Net income	(8.2)
+ D&A / noncash items	45.0
+ / - Changes in OWC	5.7
+/- Other operating	0.0
Operating cash flows	**42.5**
- Capex	(49.3)
Investing cash flow	**(49.3)**
+ / - issuances & repayments of debt	(6.9)
Financing cash flows	**(6.9)**
Net cash flows	**(13.7)**

*** Credit Case Scenario, Proj. Yr 1**

Operating cash flow (OCF) *Pull straight from CFS*	**= 42.5**
Funds from operations (FFO) = OCF - Changes in OWC	**42.5- 5.7 = 36.9**
Free Operating Cash flow (FOCF) = OCF – Capex**	**42.5 - 49.3 = (6.8)**
Levered cash flow (LCF) = OCF-ICF- debt repayments	**42.5 – 49.3 – 6.9 = (13.7)**
OCF/EBITDA (cash conversion)	**42.5/133.7 = 31.8%**

**** Can also be called Unlevered FCF if adjusted for interest**

Sources and Uses of Liquidity*

Sources	**Year 1**	**Year 2**	**Year 3**
Cash and cash equivalents	42.2	28.5	51.5
Forecast (year 1) FFO	36.9	71.4	65.6
Forecast + change in OWC	5.7	0.0	0.0
Undrawn bank lines*	93.8	93.8	0.0
Total Sources	178.6	193.8	117.1

Uses	**Year 1**	**Year 2**	**Year 3**
Projected Capex	49.3	47.3	45.2
Forecast change in OWC (if neg)	0.0	1.1	0.6
Repayment of debt	0.0	0.0	0.0
Total Uses	49.3	48.4	45.8
Liquidity Ratio	3.6 x	4.0 x	2.6 x

*** Credit Case Scenario**

SGC Financial Risk Analysis

	NO RISK	LOW RISK	INTERMEDIATE RISK	SIGNIFICANT RISK
Balance Sheet		✓		
Earnings			✓	
Cash Flow				✓
Liquidity		✓		
Overall			✓	

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Tools to Calculate Debt Capacity

Cash Flow Methodology (NPV)

- Uses unlevered free cash flows
- Assumes debt will be paid back within given time frame
- Most appropriate for Term A loans and very conservative estimates

Total Debt to EBITDA

- Most widely used in markets and covenants
- Typically based on LTM EBITDA but also common to use a "run-rate" EBITDA which is LTM or current year with expected or anticipated cost savings and synergies achieved

Debt Service Coverage Ratio (DSCR)

- Also uses unlevered free cash flows but bases calculation on one year of cash flow
- A DSCR covenant or regulator will also be applied to free cash flows to restrict the use of all cash for debt purposes

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Debt-Capacity: Operating Assumptions

Management Case

- These should be considered the best-case scenario

Credit Case

- Conservative case that reflects the bank/lenders risk
- More conservative growth and margins
- Problems that had been popping up historically do not simply go away

Downside Case

- What if it all goes wrong ?
- Could be operational issues, i.e., losing big customers, union problems, etc.
- Also could be a disaster like pandemic

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Debt Capacity – DSCR and EBITDA Methodologies*

EBITDA Multiple	
Year 1 EBITDA	133.7
Max Debt/EBITDA multiple	5.0 x
Implied Debt Capacity	**668.5**

Here the DSCR covenant is limiting the cash flow available for debt capacity analysis. The implied debt capacity is a result of the debt service analysis

DSCR	
Unlevered Free Cash Flow	61.6
DSCR covenant	1.4x
Cash flow avail for debt ★	44.0
Expected interest rate (post-tax)	3.0%
Anticipated maturity of new debt in years	7.0
All-in Debt Service Coverage Cost (3% + 1/7 years)	17.2%
Implied Debt Capacity	**255.2**

*** Credit Case Scenario**

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Debt Capacity – NPV Methodology

Cash Avail for Debt (NPV)*	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Unlevered free cash flow	61.6	47.3	43.5	41.1	31.5	32.3	28.3
DSCR covenant	1.4x						
Cash available for Debt	44.0	33.8	31.1	29.4	22.5	23.1	20.2
Expected interest rate (post-tax)	3.0%						
Anticipated maturity of new debt in years	7.0						
Implied Debt Capacity	**184.4**						

*** Credit Case Scenario**

Case Summary

ACCEPT

- Conservative balance sheet but asset/OWC intensive. Good borrowing base
- Very strong liquidity
- Good global presence and customer base
- Conservative management
- Debt capacity shows room under current EBITDA levels

REJECT

- Anemic sales growth
- High refinancing/repayment risk due to weak cash flow
- High fixed charges/sensitive to rising rates
- Many competitors in mature to in-decline industry
- Small size means downturn could send to bankruptcy

Next Steps if Risk is Acceptable

1 STRUCTURE

Type of loan (A, amortizing, B, etc.)

Where in the corporate structure?

2 PRICING & FEES (RETURN TO BANK)

Other business to consider

Syndication strategy

3 COVENANTS

Areas of weakness or concern

4 COLLATERAL

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