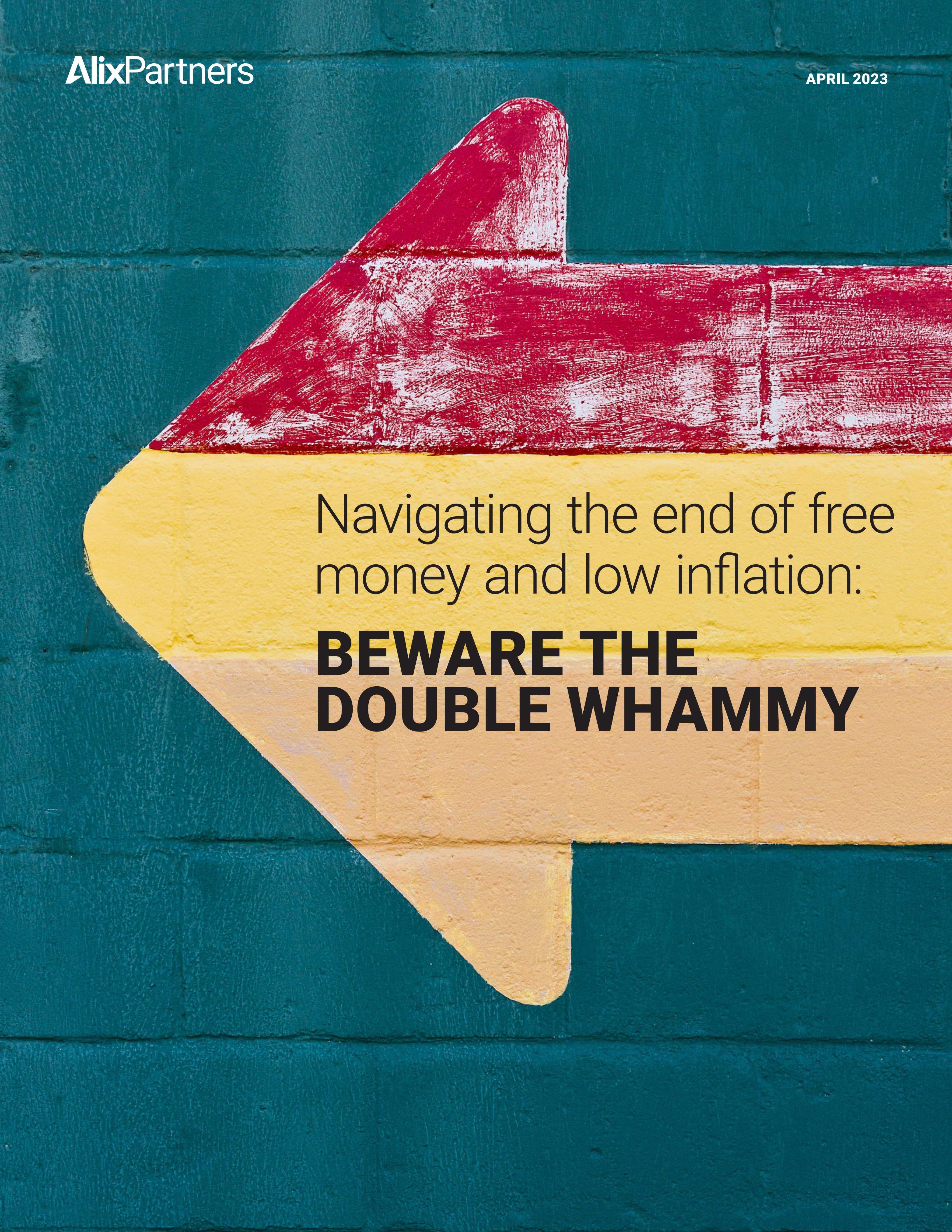


AlixPartners

APRIL 2023

Navigating the end of free money and low inflation:

BEWARE THE DOUBLE WHAMMY

For more than a decade, inflation and interest rates remained low—lower on average than at any time since the 1950s. A generation of executives made critical decisions about investments, operating models, and funding sources in an environment where inflation was barely a consideration and borrowing money was, by historical standards, free.

THAT'S OVER NOW.

A HIGHER INFLATIONARY AND INTEREST RATE ENVIRONMENT SEEMS INEVITABLE FOR THE FORESEEABLE FUTURE.

Inflationary pressures and higher interest rates are now front and center of the executive agenda. Planning for the future based on the realities of this new environment and considering areas of risk is essential.

As regulators and markets react to the recent banking disruption, many factors are adding complexity to this equation, even following the recent quarter-point rate hike. Federal guarantees for uninsured deposits, backstops for collateral lending facilities, and an assumed slowdown in the pace of interest rate hikes would, in an academic sense, naturally lead to increased inflationary pressures, counter to the Feds recent efforts to tamp down inflation.
On the other side of the equation, overall market uncertainty may lead to tighter lending standards–a "pro" in the Fed's column to reduce inflation.

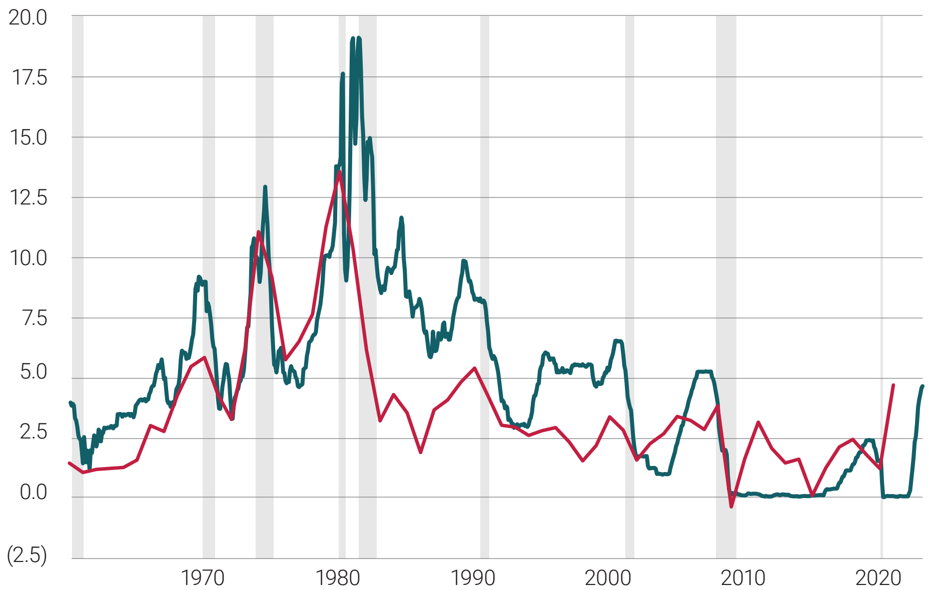
THE DOUBLE WHAMMY OF HIGHER INTEREST RATES AND INFLATION EXACERBATES UNCERTAIN OUTLOOK

	INFLATIONARY PRESSURES	DEFLATIONARY TOOLKIT	RESULTING NEAR-TERM ENVIRONMENT
BEFORE BANKING DISRUPTION	Recent market inflation driven by supply constraints, excess liquidity, and overall market enthusiasm	Increased interest rates, reducing economic activity and inflation as a result	Higher interest rates; market appears to be pricing in declines for benchmark rates but go-forward risk premium is uncertain Inflationary pressures may subside, but at slower downward trend Increased market uncertainty, and tighter lending standards overall
BANKING CRISIS RESPONSES	Guarantees of uninsured deposits Backstopped federal lending facilities Slowdown in pace of interest rate hikes	Increased market uncertainty Tighter lending standards	

With all these factors now in play, it remains unclear (a) as to the pace of and direction of future interest rates, and (b) how long inflation will remain elevated. What is clear is that an environment of both high rates and elevated inflation is likely to stay, at least in the near-term.

While many of these factors are out of management's control, **companies need to adapt now** to this new landscape by reviewing and adjusting both their operating and financial mindsets. For those who don't, the awakening will be rude indeed.

BENCHMARK INTEREST RATES AND INFLATION HAVE REMAINED LOW OVER THE PAST DECADE VERSUS HISTORICAL NORMS, BUT BOTH HAVE INCREASED RECENTLY



Federal funds effective rate
Inflation, consumer prices for the United States

Source: Board of Governors; World Bank

THE CHALLENGE:
Increased operating and financing costs

As executives review their P&Ls, the double-hit of inflationary pressures on operating costs, along with the increase in financing costs–coupled with a potential slowdown in the overall economy–will be stark.

Operating costs

Although signs of moderating inflation are starting to appear (and the effects from slower rate hikes and recent banking crises responses are too early to fully appreciate), cost pressures will likely remain elevated in the near term versus recent norms. Across the board, companies have felt the price of doing business increase with the mounting combination of wage pressures, raw material costs, shipping fees and energy prices at new highs. With that stress comes added urgency to improve operational efficiency.

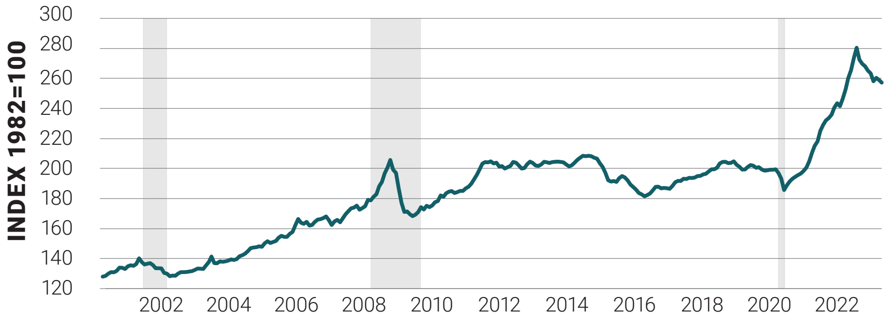
EMPLOYEE COSTS ARE INCREASING (%)

Three-month moving average of median wage growth, hourly data

Overall unweighted

Source: Current Population Survey, Bureau of Labor Statistics and author's calculations

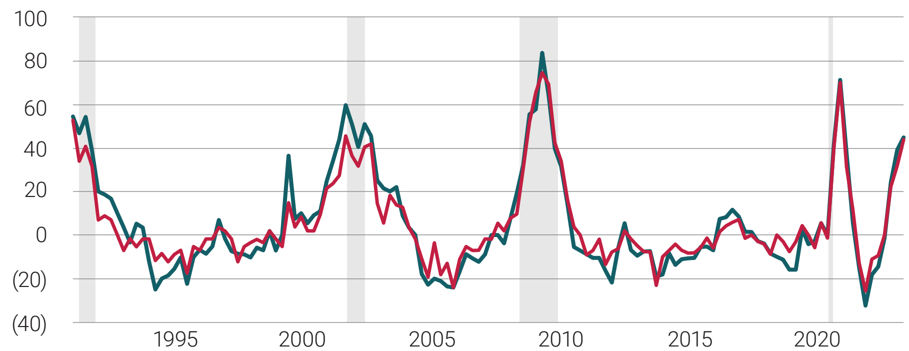
COMMODITY COSTS ARE INCREASING



— Producer price index by commodity: all commodities

Source: U.S. Bureau of Labor Statistics

LENDERS ARE TIGHTENING LOAN TERMS (%)



— Loans to large and middle-market firms

— Loans to small firms

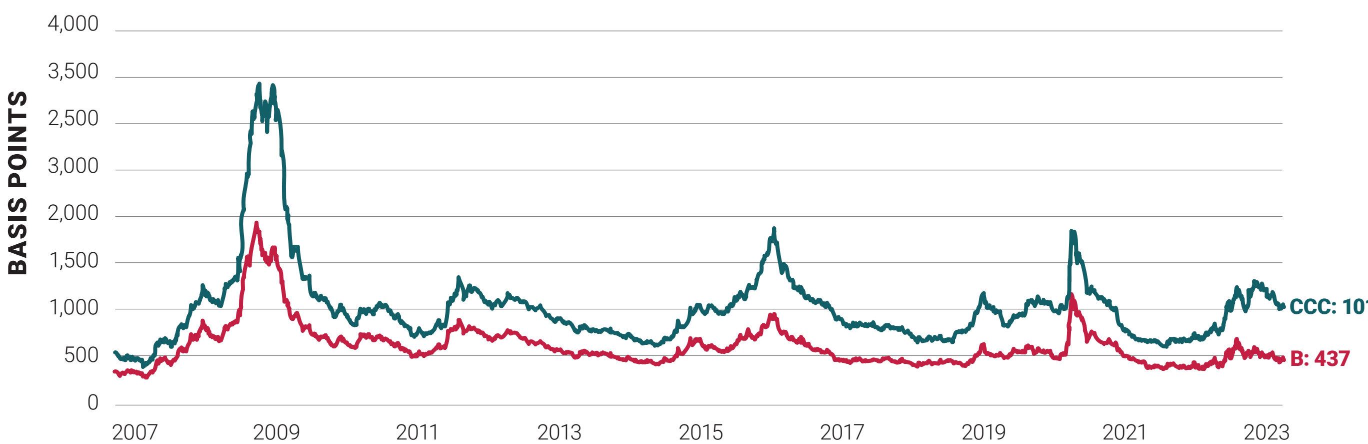
Source: Board of Governors of the Federal Reserve System (U.S.)

Financing costs

Soaring rates over the past year have amplified the financial costs and risks for companies across the industry spectrum.

- Interest-rate spreads have widened, especially for speculative-grade debt. CCC rated spreads have increased to >1000bps above treasury rates, a substantial increase vs. spreads below 600bps during much of 2021. More recently, spreads have continued to widen for lower rated credits as debt markets search for safety following the recent banking disruption.
- SOFR rates, used as benchmark for speculative and investment grade borrowers alike, have increased to over 4.5% compared to effectively 0% just one year ago[1].
- As rates have risen and lenders become more risk-averse, especially following the recent disruption, overall availability of credit may continue to tighten, as indicated by the Fed's recent survey of senior loan officers.

HIGH YIELD SPREADS



For borrowers who haven't accessed the debt markets recently or for those with variable rate debt, the cost and availability of credit may come as a shock to the system.

1. Looking forward, the market has priced in an expected drop in rates; the forward SOFR curve is forecasting an approximate 50 bps decline by the end of 2023 (to ~4%) as markets expect loosening from the Fed (source – JPM). If baseline rates do decrease going forward, credit and other market uncertainty may increase risk premiums and offset any baseline rate declines.

WHAT TO DO

To succeed in this new era of more expensive and restrictive borrowing and increased uncertainty around operating expenses, organizations need to think differently about how they finance and operate themselves:

1. Begin with an assessment of where you stand and what vulnerabilities you may have under different scenarios:

- What is your cash interest cost today versus a year ago? Where will it be next year? Are you properly hedged if rates are floating?
- What will your capital structure look like and cost when you need to refinance? Is there a large maturity upcoming? Consider how a more costly capital structure will impact cash flow and your overall liquidity profile going forward.
- What impact will increased costs have on other key elements of your budget, including Cap Ex, R&D, advertising/marketing, payroll, and other input costs?
- Who are your stakeholders, including vendors, lenders, etc.? And how will they react if things turn south?

2. Think creatively about how to address these findings

- Did you find inflationary exposure to certain expense items? What levers can you pull?
    - Can you actively hedge against raw-input or other cost increases?
    - Are you able to negotiate now with vendors today? Is my supplier base concentrated, and can we leverage other suppliers? If distressed, will the threat of a restructuring provide leverage–or have unintended consequences?
    - Can you pass through cost increases to customers?
- Are future financing costs of concern?
    - Know when, and how, to best approach your lenders. Understand who they are, and how they will likely react, before you need access to new capital.
    - Consider diversifying your capital structure. Are there unrestricted assets that can serve as collateral? Can you use creative financing mechanics to access new funds?
    - Do you understand your liquidity runway–and the options to extend it?
    - What is your business plan “story” and how will that be received by your creditors?
- Can I improve cash generation through improvements to working capital? Improved cash flow will be beneficial to any lender negotiations.

THE GOOD NEWS, FOR SOME

Although an environment of prolonged inflation and higher interest rates may be upon us, companies with steady cash flows may currently have little problem refinancing their debt. Even if current lenders balk at extending new credit, today there are a multitude of well-capitalized non-bank lenders and credit funds that appear ready and able to provide credit, albeit at higher rates and stricter terms than in the recent past.

However, not all borrowers may be able to benefit from the plethora of lenders looking to put capital to work. Cost increases will affect certain companies profoundly, such as those exposed to wage or and other input cost pressure, or that depend on consumer demand - such as home furnishers, consumer durables and used autos - are potentially at greater risk. Additionally, those sensitive to increased rates, such as mortgage lenders or companies freighted with floating-rate debt will most feel the pain of recent rate hikes. When debts come due or liquidity dries up, lenders will likely show tightened standards before providing new credit to these types of borrowers and demand more covenants when they agree to extend credit.

TAKE ACTION AND GAIN RUNWAY TODAY

The double whammy of inflationary pressures on operating expenses and higher financing rates will be material and significant for most borrowers.

Two things are critical:

1. Identify inflationary pressures within your current or future cost structure and proactively implement changes.

2. Identify financing risks and proactively consider your leverage with stakeholders (vendors and credit providers alike) and work to evaluate liquidity.

Those who gain additional runway through operating improvements and financial evaluations **today** will be at an advantage. Doing so will allow you to thrive in this environment.

AlixPartners

CONTACT THE AUTHORS:

Eric Koza
Americas Co-Leader of Turnaround & Restructuring, PMD
ekoza@alixpartners.com

Jim Mesterharm
Global Co-Leader of Turnaround & Restructuring, PMD
jmesterharm@alixpartners.com

Joff Mitchell
Global Co-Leader of Turnaround & Restructuring, PMD
jmitchell@alixpartners.com

ABOUT US

For more than 40 years, AlixPartners has helped businesses around the world respond quickly and decisively to their most critical challenges – circumstances as diverse as urgent performance improvement, accelerated transformation, complex restructuring and risk mitigation.

These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.