Weekly Credit Brief

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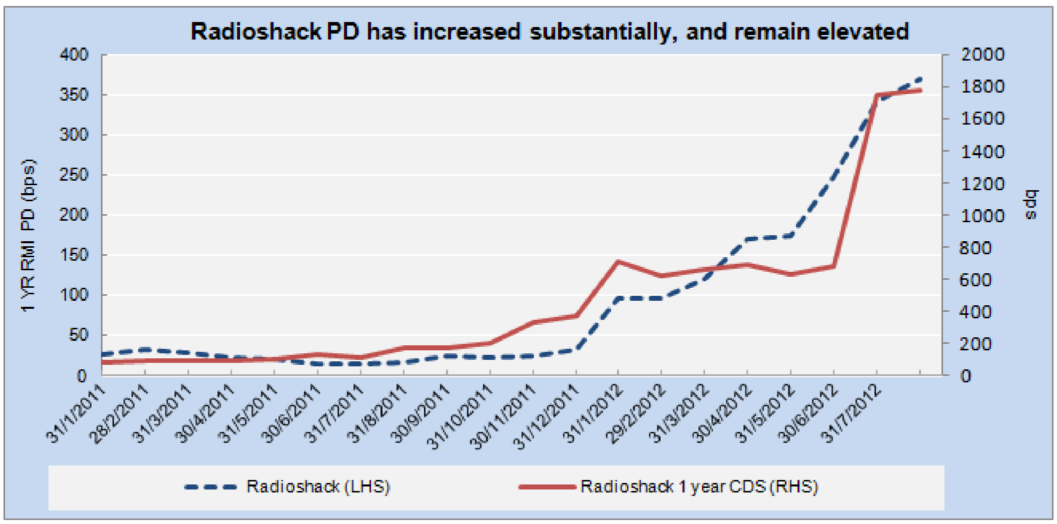
Story of the Week

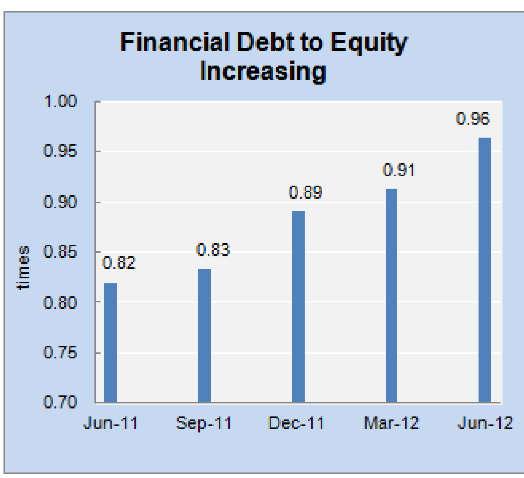
Declining profitability and liquidity concerns weigh on the credit outlook of RadioShack

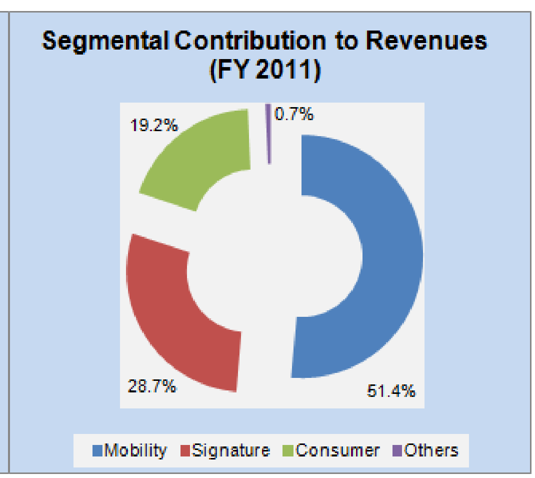
By Tan Swee Koon, Tan Theng Wei & James Weston

The 1-year RMI probability of default (RMI PD) for 91-year old US-based electronics retailer RadioShack has increased substantially, and remained elevated on August 6, on concerns that it may burn through its USD 517.7mn of cash. RadioShack faces intense competition from discount retailers and online platforms, amid a weak economy and changing consumer purchasing patterns. Its mobility-centric business strategy is subject to severe margin compression. The RMI PD for RadioShack first started to increase in January 2012, well before S&P and Fitch’s downgrades in March and April 2012, respectively.



Mobility-centric business strategy: RadioShack has three major business segments, namely mobility, consumer electronics, and their own signature electronics platform. Their primary mobility segment includes the sales of pre-paid and post-paid wireless handsets, commission income, pre-paid wireless airtime, e-readers, and tablets, which accounted for 51.4% of revenues in FY2011. This is a low margin business which operates in a highly competitive environment. In addition, sales in the company’s consumer electronics segment declined 25.2% YoY in the first half of 2012.



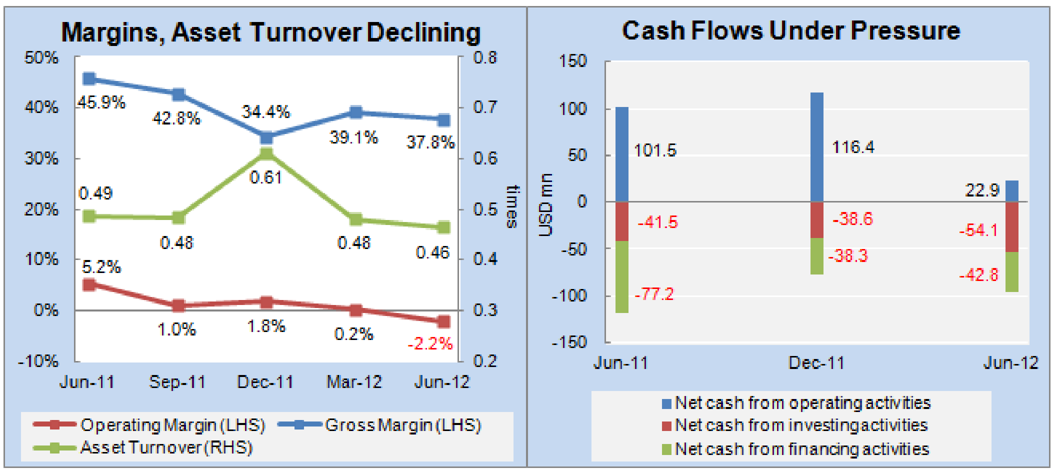


Competitive pressures: As a traditional brick-and-mortar business, RadioShack faces stiff competition from national retailers such as Best Buy and Wal-Mart. Furthermore, lifestyle changes impact the manner in which today’s smart, price-sensitive and tech savvy consumers shop. These consumers view traditional retailers as a 'showroom' in which they test mobility devices and consumer electronic products, and then go elsewhere to buy. With time being a crucial factor, such consumers prefer the ease, variety, and convenience when making purchase decisions.

Increasing online penetration has allowed consumers to compare technical specifications of products and search for the most competitive deals. In combination with secured online payment systems, these factors have fundamentally changed the dynamics of the consumer retail industry. Moreover, competition from online retailers such as Amazon.com may have accounted for a slowdown in sales at RadioShack's retail stores over the last two years. More significantly, sales at new stores were essentially flat.

Leverage: RadioShack has increased its leverage over the last five quarters. As of June 30, 2012, it had USD 679.3mn of financial debt outstanding, with the company's financial debt increasing to 0.96 times equity in Q2 2012, from 0.82 during the same period in 2011. Management intends to re-finance half of the USD 375.0mn convertible senior notes due in 2013. The three major CRAs each downgraded RadioShack further into non-investment territory during July, which may contribute to higher borrowing costs going forward.

Weakened financials: Over the previous five years operating revenues have declined. On a YoY basis, sales growth was essentially flat in the first half of 2012 and in Q2 the company's gross margin fell by 8% YoY. This severe margin compression was mainly due to price pressures amid an intensely competitive operating environment and a weak economy.



Over the previous five quarters, RadioShack's profit margins have declined and net income per share has fallen. In Q2 2012 the company reported a USD 0.21 loss per share. Moreover, the company's asset turnover has been flat. RadioShack's inventory level increased by 13.4% QoQ, versus a 5.5% decline in sales between Q1 and Q2, suggesting large inventory markdowns are likely in the near future, which could place further pressure on margins.

Reflecting the operating challenges facing RadioShack, net cash from operating activities declined 77.4% YoY in the first half of 2012, while the company's free cash flow tumbled to a deficit of USD 29.7mn in the first half of 2012, from USD 26.2mn in the second half of 2011. In order to avoid a liquidity crunch, the company suspended its dividend in Q2 2012, saving USD 50mn. The company expects that the continued suspension of dividends will allow it to pay off half of the USD 375.0mn convertible senior notes due in 2013.

Growth initiatives: In order to reinvigorate the business, management has embarked on several new initiatives, including setting up wireless kiosks at OMX and ShopKo stores. In addition, the company is pursuing several overseas expansion opportunities. A joint venture with China-based Cybermart will expand RadioShack's presence to China, Taiwan, Hong Kong, and Macau. A franchise agreement with Malaysian-based Berjaya Retail may result in 1,000 new franchise stores being opened in South-East Asia in the next decade. However, these expansion initiatives will take time to gain traction.

Sources:
[RadioShack tracks Kodak with 80% default odds](#) (Bloomberg)
[Fitch downgrades RadioShack's IDR to CCC](#) (Business Wire)
[RadioShack still suffers from old-fashioned image](#) (Wall Street Journal)

In the News

Knight Capital reaches USD 400mn deal to save company after erroneous trades
Aug 6. US-based trading firm Knight Capital announced that investors will provide USD 400mn to keep the company in business. Participating investors will receive 2% convertible preferred stock, convertible to just over 70% of outstanding stock, which will significantly dilute existing investors' stakes. This followed a software glitch on August 1 that caused the firm to take unwanted positions in 148 stocks, leading to losses of USD 440mn, almost double Knight's USD 250mn market capitalization. Regulators are examining whether Knight violated market rules. The incident highlights the risk rogue algorithmic trading systems pose to market makers and the financial system. (CNBC)

ECB acts to stave off Greek bankruptcy
Aug 4. The ECB agreed to increase the upper limit of Greek treasury bills the Bank of Greece can accept in exchange for short term loans to EUR 7bn, from EUR 3bn. This will allow the Greek government to access up to EUR 4bn of emergency loans from the Greek national bank to remain operational in the short-term. The government has EUR 3.2bn of bonds maturing on August 20. Moreover, the EU, ECB and the IMF are scheduled to make a decision in September regarding the disbursement of the next EUR 31.5bn tranche of the EUR 130bn second Greek rescue package. Provision of the funds is dependent on further budget cuts by the Greek government. (CNBC, Reuters)

S&P cuts, affirms Italian banks in sweeping changes
Aug 3. S&P downgraded 15 Italian financial institutions, and affirmed the ratings of another 15 institutions. S&P cited the increased risk to lenders loan portfolios as the Italian recession deepens. Italian banks are seen as vulnerable due to their large holdings of government bonds, which have risen in recent weeks on concerns the country's debt load may be unsustainable. Third largest lender Monte dei Pashi di Sience, which recently requested a capital injection from the Italian government, was downgraded to BBB- from BBB. S&P affirmed the two largest Italian lenders, Intesa Sanpaolo and UniCredit, at BBB+. (Reuters)

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