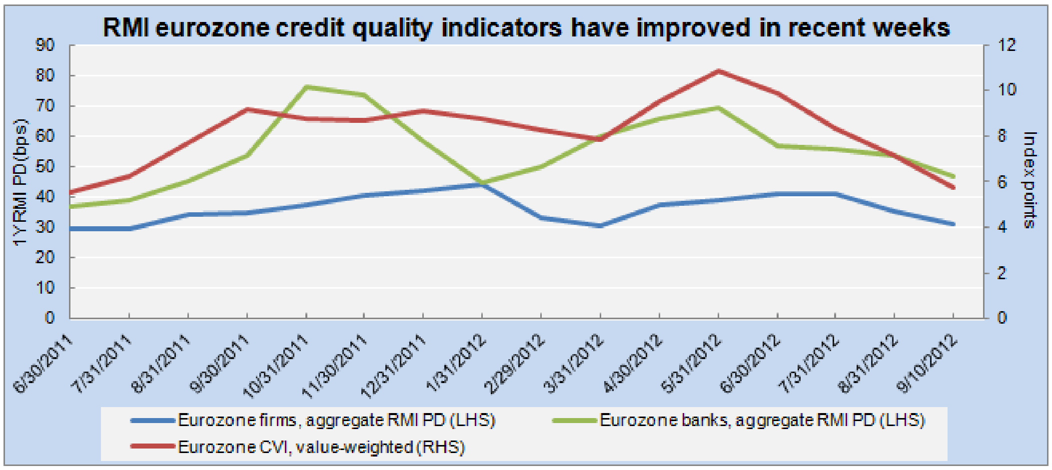
Weekly Credit Brief
Sep 4 - Sep 10 2012

Stories of the Week

ECB OMT announcement eases tensions in EZ markets; however growth, inflationary risks remain

By James Weston

RMI credit quality indicators for the eurozone improved last week, approaching levels not seen since August 2011, as the ECB announced details of its new Outright Monetary Transactions (OMTs) on September 6. These transactions will involve the purchase of bonds issued by eurozone sovereigns in secondary markets, and are aimed at easing sovereign bond yields and improving the transmission of monetary policy to the real economy. RMI PD and CVI data suggest the announcement, and recent discussions regarding OMTs, have helped ease tensions in European credit markets, as confidence in a long-delayed solution to the eurozone crisis slowly increases. However, tail risk remains, as Germany's top court is set to rule on the constitutionality of the European Stability Mechanism (ESM) on September 12.



The OMTs will be subject to strict and effective conditionality. Eurozone nations seeking OMTs must first apply for a full or precautionary program under the EFSF or ESM, and comply with the macroeconomic conditions attached to such programs. It is not yet clear if Spain or Italy intend to apply for such programs. Currently only Greece, Ireland and Portugal are taking part in EFSF or ESM programs; however OMTs will only be considered for these countries when they have regained access to bond markets.

The OMTs will be focused on the short-term section of the yield curve; sovereign bonds with a remaining maturity of between one and three years will likely be purchased, in line with the ECB's short-term policy rates and past refinancing operations. The ECB said there was currently no limit set on the overall size of purchases. Furthermore, the ECB will accept the same seniority as other creditors on OMTs, reducing fears that investors would demand higher risk premiums due to subordination, as has occurred in past ECB purchases of sovereign bonds.

Yields on Italian and Spanish bonds last week fell to the lowest levels since early-April. While OMTs will likely support sovereign access to bond markets, the market will likely test the ECB's resolve, as similar programs in the past were largely unsuccessful. The ability of eurozone governments to implement large fiscal and structural reforms, and meet conditionality requirements, will continue to be assessed in the marketplace. However, increasing focus on continued short-term budgetary curtailment will likely impact overall eurozone growth, a credit negative for European corporates.

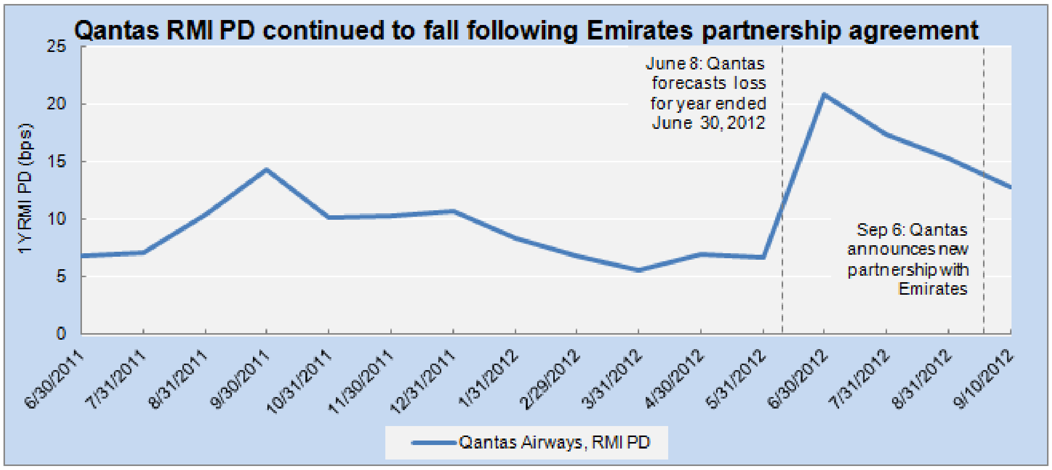
During the same press conference, the ECB also said it would keep its key interest rates unchanged. The ECB expects inflation will remain above 2% through 2012, and fall slightly during 2013. Renewed turmoil in financial markets has the potential to affect growth and inflation, part of the reason the ECB has implemented OMTs. The OMTs would be fully sterilized in order to reduce the inflationary effects of the transactions, but market participants remain concerned that this would be impossible while the ECB continues to offer European banks unlimited liquidity on a collateralized basis.

Moreover, the ECB made it easier for European banks to access its liquidity facilities last week. The ECB said it would accept debt securities issued in the eurozone but denominated in other currencies as collateral, re-introducing a framework used between late-2008 and 2010. In addition, the ECB suspended the application of a minimum credit rating threshold on collateral issued or guaranteed by countries eligible for OMTs. These changes are a credit positive for European banks, as it should reduce short-term funding pressures, and reduce collateral 'cliff risk' should a larger eurozone nation seek a bailout from the EFSF or ESM in the near future.

Sources:
Technical features of Outright Monetary Transactions (ECB)
Measures to preserve collateral availability (ECB)
Germany's top court to decide rescue fund's fate (MarketWatch)
The myth of ECB sterilization (eFinancial News)

Qantas tie up with Emirates a credit positive despite competition

The RMI 1-year probability of default (RMI PD) for Qantas Airways continued to fall over the past week, with the airline announcing a 10-year 'partnership of peers' with Dubai-based Emirates on September 6. The partnership will lead to a significant restructuring of Qantas' international services, and will likely see the business unit return to profitability in the long-run, and arrest a recent credit deterioration.



Qantas recorded a net loss of AUD 287mn for the six months ended June 30, despite soaring demand for international travel in Australia. The company's first loss since 1996 was largely caused by its currently unprofitable international operations, which lost around AUD 450mn in the financial year ended June 30. The partnership will see Qantas move its European transfer hub from Singapore to Dubai, making use of the world's only purpose-built A380 terminal.

Beginning in April 2013, Qantas and Emirates will together begin operating 98 weekly services between Australia and Dubai, a 24-hour hub with one-stop connections to over 33 European destinations, with seven European destinations serviced by Airbus A380s. Qantas simultaneously announced it was ending its joint business with British Airways. The move to Dubai should significantly improve Qantas' competitive edge on European services; a partnership between Etihad and Brisbane-based Virgin Australia currently allows both airlines to offer four times as many international destinations to Australian travelers.

The agreement will involve considerable integration of the two airlines international routes, and coordination on pricing, sales and scheduling issues, subject to regulatory approval. Moreover, the agreement will likely lead to a streamlining of overall capacity on long-haul routes between Australia and Europe, improving margins, and allowing Qantas to refocus capacity on the lucrative Asian market. Qantas currently serves a majority of Asia through stopovers in Singapore on its long-haul 'Kangaroo Route' as an 'afterthought' to services to Europe.

Moreover, this will allow Qantas to significantly improve its services to Asian markets, with an overall goal of meeting increased demand for direct access to Asian region, especially for business customers. This will also allow Qantas to optimize the use of capital dedicated to Jetstar, its extremely profitable budget subsidiary, and to domestic routes, particularly the Melbourne to Sydney route. The company is facing increased competition for business customers from Virgin Australia on this route, the fifth busiest in the world.

This broad operational restructuring will likely reverse a slight deterioration in the company's overall credit profile. Qantas' interest coverage ratio fell to 1.33 times during the six months ended June 30, while the current ratio fell to 76.71% during the same period, from 87.99% at the end of 2011. Cash levels remain adequate at AUD 3.4bn, near the five-year trend. However, continuing high fuel costs, and maintenance costs around 30% higher than competitors, could constrain liquidity. Qantas has no bonds maturing before 20 June, 2013, when USD 900mn of 5-year bonds fall due, but has over AUD 3bn of secured loans outstanding tied to aircraft and other facilities for which it does not specify an average maturity date. As at June 30, its net debt to equity was 53.51%, down from 54.56% at the end of 2011, but well above the 5-year average of 41.17%.

Sources
Qantas, Emirates announce global aviation partnership (Qantas Airways)
Qantas Airways ties up with Emirates (New York Times)

In the News
Asia-Pacific syndicated loans slowest in 7 years **Sep 4.** Asia-Pacific syndicated lending growth is slowing, as companies face rising borrowing costs and opt for private bilateral facilities and bonds. Bloomberg data shows just USD 29bn of syndicated loans have been signed in the Asia-Pacific region since July 1, down 65% from the same period in 2011. Average interest margins on USD-denominated facilities in Asia rose to 303.2bps in Q2, from 264bps in Q1. Corporate bond sales globally reached a record high of USD 237bn in August as market yields on benchmark sovereign bonds fell to record lows. Asian firms are also making increasing use of bilateral facilities as they prefer to keep loan terms confidential. (Business Times)
PBOC takes major step towards liberalizing rate regime, bank loan rollovers increase **Sep 9.** The PBOC is increasingly focusing on using reverse repos to guide domestic interest rate expectations, as the central bank looks to reform interest rates as foreign capital inflows slow. In the absence of overwhelming inflows of fresh liquidity from abroad, the financial system has become more dependent on liquidity provided by PBOC, with reverse repos becoming a key part of the PBOC's open market operations since May. This is a reversal for banks that were previously so flush with funds that they could refuse to deal with the PBOC entirely. In related news, the WSJ reports that loan rollovers are becoming increasingly popular at Chinese banks as the economy slows. Market participants are concerned such practices delay the recognition of bad loads, and may limit the funds Chinese banks have available to lend going forward. (Reuters, WSJ)

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