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# Electronics giant Panasonic faces growing headwinds

by XIA Xinyao

In March 2016, Panasonic, Japan's leading electronic producer, scrapped its lofty ambitions of achieving 10 trillion yen in group sales for the fiscal year ending March 2019, which coincides with its 100th anniversary. The bleak global business outlook has prompted the management to reconsider Panasonic's expansion strategy and, subsequently, the decision was made to take a prudent approach. Even before the announcement, Panasonic's stocks have taken a heavy beating in the Japanese stock exchange – declining by over 45% since end May 2015. While the decline in share price mirrors the weakness in the broader equity markets, the company's stock has underperformed the index after it reported a USD 138mn decrease in operating income for Q2 2015. As a result, its RMI-CRI 1-year Probability of Default (PD) has climbed, from 2.5bps in May 2015 to as high as 14bps in Q1 2016.

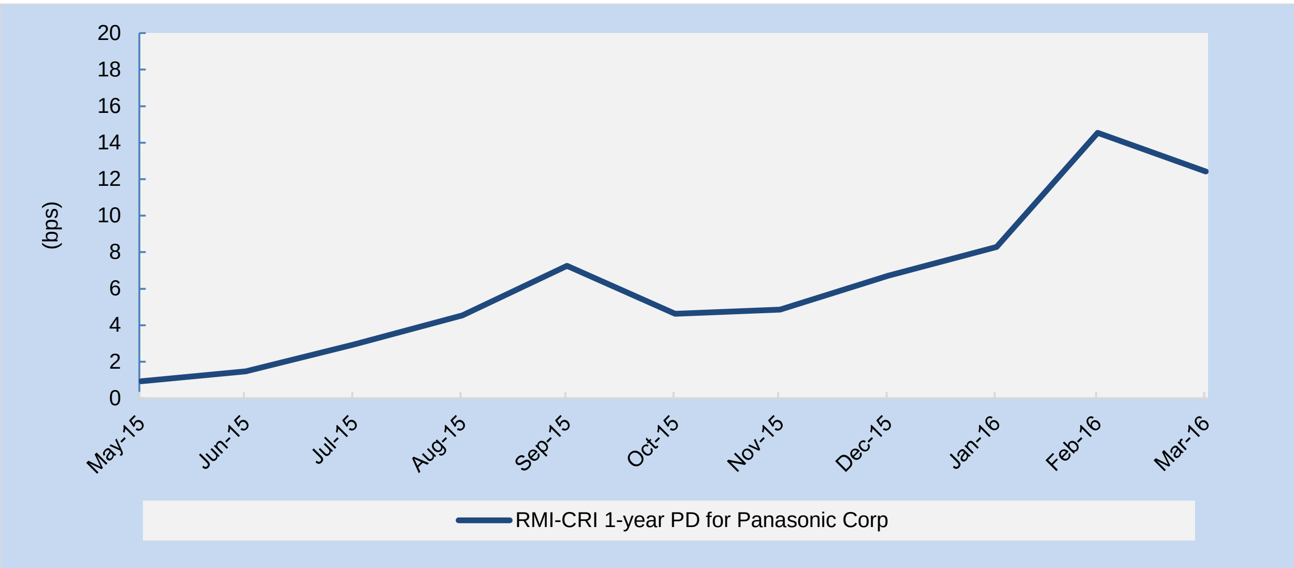


Figure 1: The RMI-CRI 1-year PD for Panasonic Corp *Source: RMI-CRI*

According to the latest Tankan survey, which is a short-term economic poll of enterprises by the Bank of Japan (BOJ), the business sentiment of major manufacturers has deteriorated to the lowest in nearly three years. The results underscore corporate Japan's concern over the murky, global economic outlook. It also came on the back of an economic contraction in Japan, which shrank during the October-December 2015 period due to weak exports and consumption.

The adoption of negative interest rates by the BOJ pushed the yield on benchmark 10-year Japanese government bonds to a record low of 0.02%, a week after the central bank's announcement in January 2016. The record-low debt yields have created problems for corporate pension plans, which depend on the returns earned from high-grade bonds. Now, companies need more assets to generate the same amount of returns. As declining yields enlarge the present value of pension liabilities, shareholders of the company stand to see the value of their investments being chipped away by rising pension obligations. Panasonic is on Bank of America Merrill Lynch's list of vulnerable companies, along with Sharp Corp, Toshiba Corp and NEC Corp - all of which have high pension liability to equity ratios.

Moreover, the yen's sharp appreciation is expected to affect companies' earnings. Given that businesses do not adjust their exchange rate assumptions frequently, earnings forecast revisions tend to lag behind actual changes in the forex market. Panasonic, for instance, used an exchange rate of 115 yen to the dollar in its projection, which is significantly weaker than the currency's April 1 spot price of 112.19. The latest Tankan survey suggests that the exchange rate projected by large Japanese companies in their earnings projection was a generous 117.46 yen to the greenback for fiscal year 2016. This indicates that Japanese firms have not fully factored in the likely appreciation of the yen.

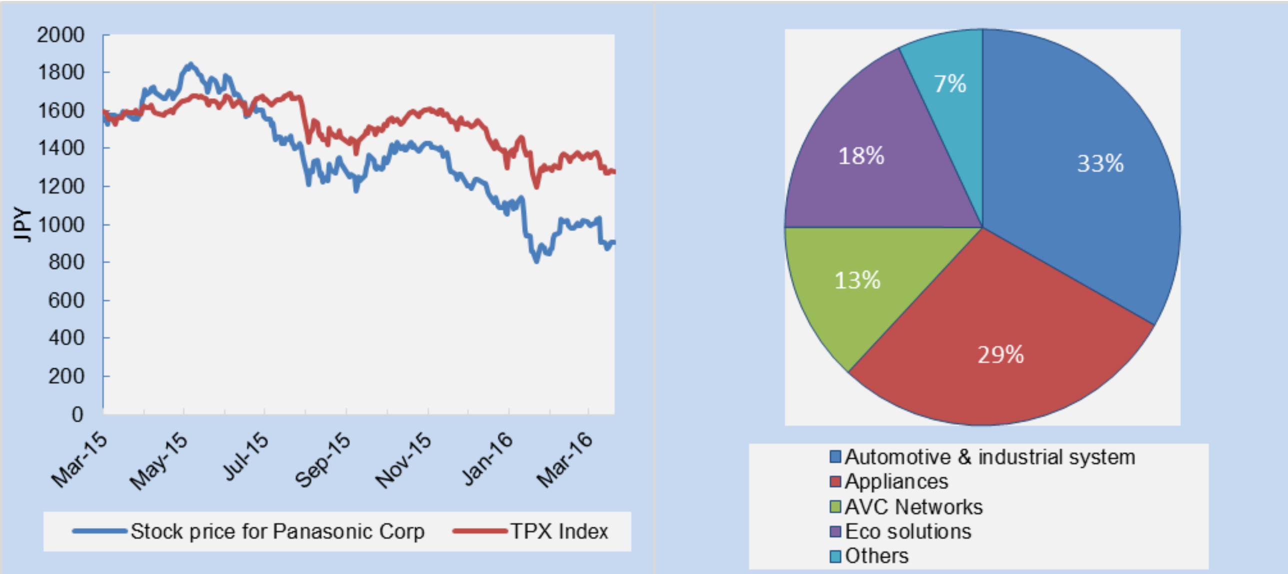


Figure 2: Stock price for Panasonic Corp compared to Tokyo Stock Exchange Tokyo Price Index (TPX Index) on the left panel; revenue breakdown of Panasonic by products in Q4 2015 on the right panel *Source: Bloomberg*

The underperformance of Panasonic's share price against the market is mainly driven by falling operating profits (see Table 1) and the drawbacks of its investment strategy. Panasonic's revenue stream comprises five segments (see Figure 2): automotive & industrial system (AIS), appliances, AVC Networks and Eco solutions (ES). AIS, the biggest revenue contributor, has witnessed a continuous downward trend due to low IT demand and intensifying competition. Although Panasonic remains the largest battery supplier for electric cars, LG Chem and Samsung SDI are rapidly catching up with strong sales growth in 2015. A slower recovery in the Japan housing market and the weakening solar panel market also resulted in softer performance in its ES business. The non-core operation has also steadily contributed less revenue. Overall, the only bright spot in Panasonic's sales report appears to be the appliance segment, which seems to be recovering after robust sales in refrigerators and washing machines.

| | | 3/31/2015 | 6/30/2015 | 9/30/2015 | 12/31/2015 |
|---|---|---|---|---|---|
| **Revenue by Products (USD mn)** | Automotive & industrial system | 6954 | 5398 | 5291 | 5202 |
| | Appliances | 5047 | 4403 | 4193 | 4497 |
| | AVC Networks | 3089 | 1999 | 2179 | 2053 |
| | Eco solutions | 5367 | 2573 | 2816 | 2819 |
| | Others | 2973 | 998 | 1267 | 1091 |

Table 1: Quarterly revenue by products of Panasonic Corp *Source: Bloomberg*

Panasonic's investment strategy has resulted in tighter free cash flow for the company (see Table 2). The acquisition of Hussmann in December 2015, a manufacturer of refrigeration and food merchandising equipment, would position Panasonic for longer term growth but, at the cost of USD 1.54bn, heavily restricts the free cash flow of the company. Additionally, in the March 2016 business policy meeting, the management affirmed that Panasonic's mid-term strategic investment totaling JPY 1 trillion remains unchanged and that the company will continue to focus on expanding its AIS and ES businesses. The acquire-to-grow strategy could put further strains on the cash flow of the company should Panasonic decide to finance the acquisitions by issuing debt.

| | 12/31/2014 | 3/31/2015 | 6/30/2015 | 9/30/2015 | 12/31/2015 |
|---|---|---|---|---|---|
| **Free Cash Flow (USD mn)** | 1,293.7 | 456.0 | 249.7 | -190.4 | 343.8 |

Table 2: Quarterly free cash flow of Panasonic Corp *Source: Bloomberg*

The second half of April 2016 will be a busy period for Panasonic as it prepares to release its Q4 FY2016 quarterly report and the FY 2016 annual report. If the current share price is any indication, it is widely expected to report weaker financial results. Despite the shortcomings, Panasonic's financial strength remain largely intact. The company continues to be profitable, even in the current, tough business environment. The resilience would provide assurance that the company has sufficient resources to weather the economic storm. While the recent sell-off of its shares in the equity markets may have tested its credit strength, the company is unlikely to face any unsurmountable financial difficulties in the near to medium term.

**Credit News**

**Pacific Exploration postpones board meeting on debt restructuring**

**Apr 10.** Debt restructuring efforts by Pacific Exploration & Production Corp have been delayed after shareholders said that the latest restructuring proposal would benefit the co-chairman, at the expense of the other stakeholders. Founded in 2003, Pacific Exploration & Production Corp is struggling with debt payment after the plunge in oil prices affected the firm's ability to service its debt. Once Colombia's second largest company by revenue, Pacific Exploration has been forced to cut its debt and reduce interest payments. The company's share price has dropped more than 90% from its 2012 level. (WSJ)

**World Bank lending at record since aftermath of financial crisis**

**Apr 10.** The World Bank issued nearly USD 30bn of loans in the recent fiscal period, breaching the record set during the 2008 financial crisis. Part of the loans will help countries in crises ranging from civil conflict regions, illegal refugee migration and Ebola-affected areas. Commodity exporters reeling from budget deficits due to the drop in commodity prices have also requested funding from the World Bank. Shareholders are considering allocating more resources to the World Bank, as more countries are asking for help with their fiscal balances. Managers at the bank have reduced operating costs by USD 400mn and have found new ways to leverage on existing assets. (Bloomberg)

**Teen retailer Pacific Sunwear files for bankruptcy**

**Apr 7.** California-based US retailer Pacific Sunwear will not be closing its 600 stores nationwide after it filed for Chapter 11 bankruptcy on April 7. The company lost considerable market share to competitors in the fast fashion and online shopping industries and posted its first annual loss since 2008. According to the court docket, the company has assets with an overall value between USD 50mn to USD 100mn, and liabilities in the range of USD 100mn and USD 500mn. Nike and Simon Property Group were mentioned as creditors to the firm, while Wells Fargo has a debtor in possession credit agreement with the firm. (Reuters)

**China's Winsway enterprises files for US bankruptcy protection**

**Apr 7.** Chinese coal company Winsway Enterprises Holdings has filed for bankruptcy protection in the US as part of a proposed plan with its bondholders to restructure more than USD 349mn in debt. The Hong Kong-listed company has been losing money for several years as its coal operations suffered in the wake of cooling demand for Chinese steel. It filed for protection under Chapter 15 of the bankruptcy code in US Bankruptcy Court in New York, a day before the bonds are set to mature. Chapter 15 bankruptcy is designed to allow troubled international companies to shield US assets while they work out their financial troubles elsewhere. (WSJ)

**Default rates of private equity loans are creeping up**

**Apr 6.** Default rates of loans related to private equity firms have increased steadily for the first three months of 2016. It stood at 1.46% as of March 31, up from 0.96% as of Feb 29, and 0.88% as of Jan 31 according to data from Standard & Poor's Capital IQ's Leveraged Commentary and Data (LCD) unit. The data track loans borrowed by the portfolio companies of private equity firms for such purposes of financing new buyouts, refinancing debt and dividend payouts. Although default rates this year are still below historical average of 3.1% for all leveraged loans, the outlook for default rates is not rosy. Loan investors and portfolio managers responding to a March survey said they anticipate default rates to climb modestly in the next two years. The energy sector is expected to yield more defaults. (WSJ)

**Valeant gets lender deal to waive default, loosen debt terms** (Bloomberg)

**PacSun said to accelerate bankruptcy filing after negotiations** (Bloomberg)

**African bank debt shunned by investors after rescue succeeds** (Bloomberg)

**Regulatory Updates**

**Heta's creditors forced to share losses by Austria regulator**

**Apr 10.** Austria became the first European country to use a new law to share losses of a failed bank with senior creditors as it slashed the value of debt owed by Heta Asset Resolution AG. The Austrian banking regulator cut Heta's senior liabilities by 54% and extended the maturities of all eligible debt to Dec 31, 2023 to cover a USD 9.1bn hole in Heta's balance sheet. The regulator also wiped out the company's equity and junior liabilities as well as supplementary capital. Interest payments were canceled from March 1, 2015, when the FMA first put Heta into resolution. Some creditors have already challenged the FMA's decision to apply European bank resolution rules to Heta. (Bloomberg)

**Lenders' fears ease over Basel absolute leverage regulations**

**Apr 6.** Banks with sizeable derivatives portfolios will not be as badly hurt as they feared by new regulations capping lenders' absolute leverage. National rules are already in place, but the Basel Committee of Banking supervision is hammering out a global package that will become binding in January 2018. The basic requirement is for capital to equal at least 3% of total assets. The latest draft shows that banks will be able to use clearing houses to reduce the size of their derivatives books, in certain circumstances, for the purposes of leverage ratio calculations. This will reduce the lenders' assets, and ultimately leave them with a lower leverage ratio requirement, since the requirement is calculated on the basis of a set percentage. (FT)

**Kenya central bank to help banks that face liquidity pressure** (Reuters)

**China to ease risk curbs on brokerages as margin finance plunges** (Bloomberg)

**Chinese government warned over plans for 'painful' swaps of bad debt for equity** (SCMP)

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