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Uncertainty spikes in scandal-laden auto industry

by KHAW Ker Wei

Just barely half a year since Volkswagen AG (Volkswagen) shook the automotive industry with news of its wrong-doing, the industry was dealt another blow in mid-April 2016 when Mitsubishi Motors (Mitsubishi) announced that it had cheated on the fuel economy of its minicars. The recent spate of misconducts instinctively calls into question the extent of cheating committed by automakers just to meet regulatory requirements. Perhaps, the fact that even reputable carmakers like Volkswagen had to resort to under-handed methods to mask its environmental footprint makes it a more disheartening affair. The same goes for Mitsubishi, a part of corporate Japan that is known for its commitment, discipline and honesty. The company was also embroiled in a safety scandal back in 2004 and apparently, the lesson was not learnt. In view of these incidents, the regulatory risks for the sector are likely to rise and already, federal probes are underway in several countries involving major carmakers.

Volkswagen's misstep cost it the claim to the top spot in the global automotive rankings. Just before the scandal came to light, it led the worldwide sales rankings with sales of 5.04mn units, to Toyota's 5.02mn units during H1 2015. That dream was put to rest, at least for now, when it was revealed in September 2015 that the company had installed defeat devices to understate the emission of nitrogen dioxide during tests for diesel vehicles sold in the US, which has a more stringent emission standards compared to Europe.

The RMI-CRI 1-year Probability of Default (PD) for Volkswagen climbed to almost 30bps (see Figure 1) following the revelation of the scandal, driven by shrinking market capitalization as a result of the sell-off of its shares. The PD has improved gradually over the next two quarters to about 17bps as of 22 April 2016, supported by a healthy balance sheet, with its cash and cash equivalents totaling in excess of EUR 22bn in the last-available financial report.

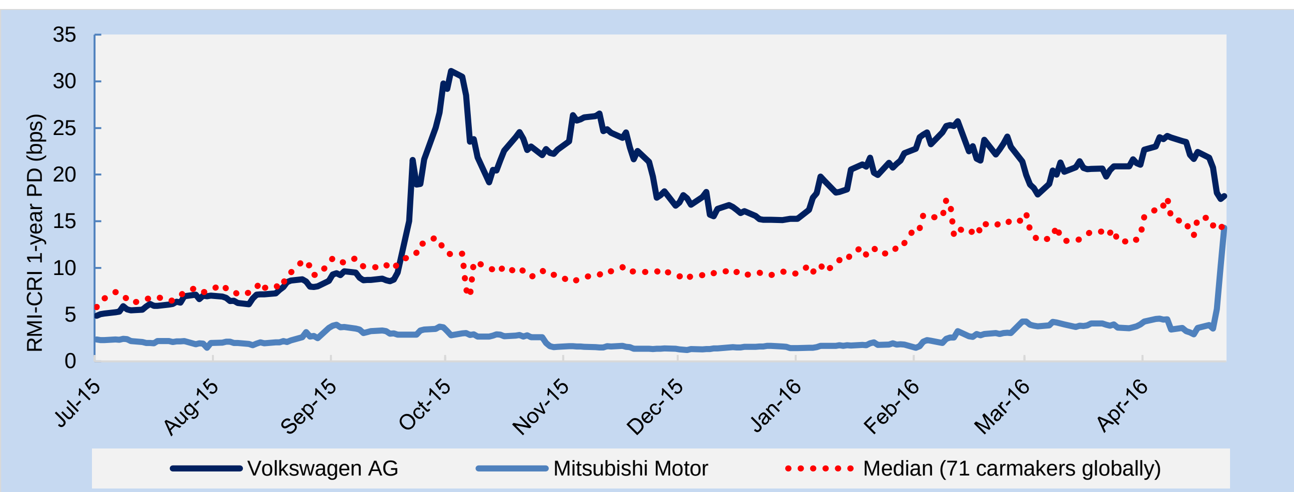

Figure 1: RMI-CRI 1-year PD for Volkswagen, Mitsubishi and the median for 71 carmakers globally *Source: RMI-CRI*

In the immediate reporting quarter when the wrong-doing was made known, Volkswagen booked EUR 6.7bn for expenses related to the recall of the affected diesel vehicles. In April 2016, the provisions more than doubled to EUR 16.2bn after an agreement was reached with the US authorities to settle civil claims. Industry analysts believe that the final cost of the scandal could be as high as EUR 38bn. While the Volkswagen brand has suffered a reputational damage, evident from the drop in the delivery of passenger cars year-over-year (-2.7%), as well as during the latest quarter (-1.3%), the company's sales line is well diversified and group sales expanded by 0.8% during the first quarter of 2016. Over the next quarters, the profitability of the company is anticipated to suffer but given the strong cash position and the resilience in sales performance, this is unlikely to result in any major pecuniary concerns to the company at this stage.

In comparison, Mitsubishi's scandal appears to be less serious. After all, another two leading, Asian carmakers were caught for a similar offense in 2014. That year, the Hyundai Motor and Kia Motors jointly-operated companies in the US agreed to pay USD 300mn in penalties and nearly USD 400mn in reparations to customers for overstating fuel economy on 13 vehicle models. If the case were to serve as a precedence, Mitsubishi's legal financial liabilities would be significantly less than that of Volkswagen's.

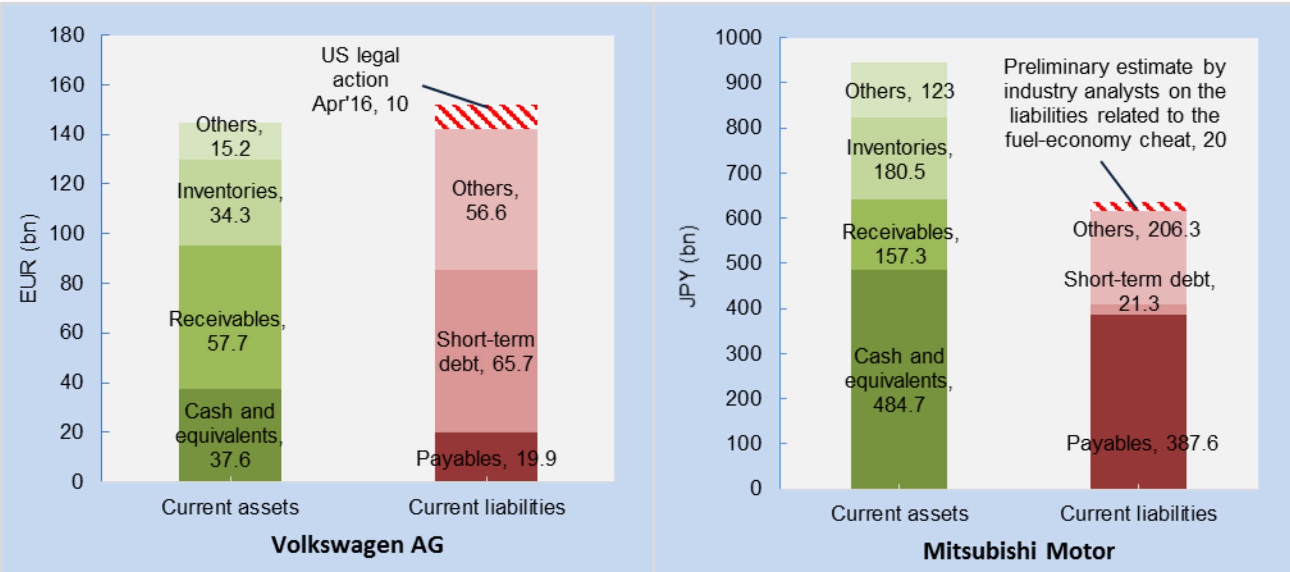

Figure 2: Current assets, current liabilities from the last-available balance sheet and the estimate of penalties related to the scandals for Volkswagen (left) and Mitsubishi (right) *Source: Bloomberg*

However, Mitsubishi, as a small player in the market, has less room for errors. The company still held a healthy balance of JPY 484.7bn in cash and cash equivalents as of the end of 2015 (see Figure 2). It should have sufficient resources to meet the expenses arising from legal claims related to the fuel-economy cheat. Beyond that, a bigger hurdle lies in wait for Mitsubishi. The company also admitted that the procedures used for testing passenger cars were not compliant with the Japanese standards. While the size of the financial damage cannot be ascertained until the Japanese government completes its investigation, the seriousness of the matter cannot be downplayed. Mitsubishi's president has acknowledged openly that the financial impact from the fallout would be huge.

With Mitsubishi deciding to halt the production and sales of its minicars, the company's credit strength is set to be tested severely. In the past three years, Mitsubishi sold a total of 3.6mn units of vehicles globally, of which, more than 600,000 units were those implicated in the scandal. While the profit margin from minicars is low, the loss of revenue will immediately eat into the profits from other segments, unless Mitsubishi is able to swiftly redeploy its resources into the other product lines and ramp up their sales, or shed off the production of minicars completely. The company may also be required to provide compensation to Nissan, which bought 468,000 units from Mitsubishi under an outsourcing contract to rebrand and sell, for the breach in supply agreements. Following the exposure of the scandal, the RMI-CRI 1-year PD for Mitsubishi rose sharply from 3.9bps in March 2016 to 14.3bps as of 22 April 2016 (see Figure 1). Taking into consideration the prospect of weakening fundamentals, it is very likely that the PD of the company will continue to deteriorate in the coming months as the financial impact from the event materializes.

The second decade of the 21st century could prove to be a pivotal moment for the automotive industry. More than a century after the first cars were mass-produced, global changes are steering the industry towards a total overhaul. The ever stricter environmental regulations would increasingly reduce the competitiveness of fossil-fired vehicles, while opening up opportunities for newer technologies. Indeed, the carmakers' need for research and development has never been higher, seeing that major tech companies are getting closer by the day, to disrupt the automotive industry with innovations such as the autonomous driving and the web connectivity technologies. Regardless of the strategies preferred by carmakers, be it to partner a technology player or to develop the capabilities internally, one thing seems certain at this point: cheating does not pay.

Credit News

Hanjin Shipping falls by record on debt reform uncertainty

Apr 25. Hanjin Shipping Co. fell the most since it began trading in 2009 because of investor uncertainty over whether a proposal by South Korea's largest container carrier to restructure debt would help improve its financials amid years of low rates in the cargo-transportation industry. Hanjin Shipping has been unprofitable for the last five years. Its cash on hand fell 56% from a year earlier to 241 billion won (USD 211mn) at the end of 2015. The company said it has 389 billion won in bonds maturing this year. Of the 238 billion won that's due in June, it plans to roll over 48 billion won. (Bloomberg)

China risks mount as debt hits new record

Apr 24. China's total debt rose to a record 237% of gross domestic product in the first quarter, far above emerging-market counterparts. Beijing has turned to massive lending to boost economic growth, bringing total net debt to RMB 163tn (USD 25tn) at the end of March, including both domestic and foreign borrowing. While the absolute size of China's debt load is a concern, more worrying is the speed at which it has accumulated — Chinese debt was only 148% of GDP at the end of 2007. New borrowing increased by RMB 6.2tn in the first three months of 2016, the biggest three-month surge on record and more than 50% ahead of last year's pace. (FT)

Retailer Aeropostale is reportedly close to filing for bankruptcy

Apr 22. The teen-focused retailer has been facing financial trouble for some time as sales and profits have dropped off. The company reported in March that comparable sales were down 6.7% year over year. The brand has fallen out of favor with teens and the company has attempted to revive the brand by enlisting Youtube stars and starting a blog to attract their target audience. The New York Stock Exchange has also issued a warning to the company that its share price was dipping so low that it may be de-listed. The stock is down 14% after the report at USD 0.18 a share. (Business Insider)

SunEdison's ambitions end in bankruptcy

Apr 21. After several years of rapid debt-fueled growth SunEdison filed for bankruptcy due to immediate liquidity issues. Nevertheless SunEdison plans to continue day-to-day operations while in bankruptcy. SunEdison's listed affiliates TerraForm Power and TerraForm Global are not included in the filing, but bankruptcy experts have warned there is a risk that they could be dragged in by legal actions from creditors. As SunEdison being the world's largest renewable energy developer, the bankruptcy is likely to be felt well beyond the US but is not expected to have a material impact on the solar power industry worldwide. (FT)

Inca One Gold announces debt restructuring

Apr 19. The Canadian-based mineral resource company Inca One Gold Corp with a gold milling facility in Peru announced a debt restructuring and an additional USD 3mn convertible debenture offering. This amounts to approximately 30% of debts that will be canceled and re-issued into new convertible debentures. Another 50% of debts will be converted to common shares at CAD 0.11 per share and approximately 20% will be converted to contingent debts payable on certain performance metrics being met or warrant deposits held by Inca One. The signed commitment letters with the lenders totals about USD 10mn. (Reuters)

Nigeria to pay states' bondholders despite March debt deferral (Bloomberg)

Seventy seven energy plans to file for bankruptcy (WSJ)

ANZ, CBA face debt risk as energy producers wilt (Sydney Morning Herald)

Regulatory Updates

ECB is having second thoughts on 'coco' bonds

Apr 24. The European Central Bank is having second thoughts about the hybrid securities, contingent convertible bonds (cocos), which are designed to bolster the capital of banks but caused panic among investors this year. Cocos are a key pillar in the regulatory regime drawn up to strengthen banks' capital levels and prevent taxpayer bailouts after the financial crisis. But while they are supposed to increase financial stability, concerns about them helped whip up market volatility in February. (FT)

Banks face tighter rules on interest rate risk in Basel revamp

Apr 21. Basel Committee on Banking Supervision beefed up rules for tackling interest-rate risk in banks' loan books, but stopped short of imposing binding capital requirements after fierce opposition from the financial industry. Banks pilloried a proposal last year to replace the existing supervisor-led approach with minimum capital requirements set centrally by the Basel Committee. The updated rules published on Thursday pertain to customer loans and other assets that lenders expect to hold for long periods, or to maturity, and whose current value can vary when rates change.(Bloomberg)

Shanghai CBRC to halt banks' business with six property agencies (Bloomberg)

Singapore authorities investigating brokers for possible breach (Bloomberg)

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