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Weekly Credit Brief Aug 11 - Aug 17

Tata Steel says ta-ta to its glory days

by Samuel Lim

The steel industry has been hit by a double whammy of poor demand and a supply glut. Just last week, steel billet was trading close to its 1-year low at just over USD 120/ton. On Aug 11, China allowed the Chinese Yuan (CNY) to devalue, resulting in a depreciation of the CNY against USD by 2%. As a result, the CNY depreciated by 1% against the Indian Rupee (INR). The devaluation exacerbated the problems faced by the Indian steel sector as Chinese steel products became relatively cheaper.

Headquartered in India, Tata Steel is one of the world's largest steel producing companies and it has subsidiaries in Europe and Southeast Asia. It has operations in 26 countries, a commercial presence in over 50 countries and 80,000 employees around the world. Tata Steel's business model involves a vertical integration of steel production from mine-to-manufacture-to-customer. This model has helped to reduce the cost of production as Tata Steel is able to save on any markups paid to middlemen. Cheaper Chinese steel imports have piled pressure on steel prices and adversely affected Tata's profits in its European and Indian markets. Its European subsidiary cut 720 jobs at its steel marking facility in Rotherham, UK this July, stating that its steel bar business had not been performing well and that it was not able compete well with its European counterparts. Even though India's steel prices have fallen by 20% since last year, consumers prefer to buy China imports as they are cheaper than India's steel. The market capitalization of Tata Steel has fallen from INR 478bn on June 2, 2014 to INR 231bn on August 14, 2015. Its RMI-CRI 1-year Probability of Default (PD) has skyrocketed from 78.8bps on June 2, 2014 to 543.4bps on August 14, 2015, indicating a deteriorating credit rating of the company.

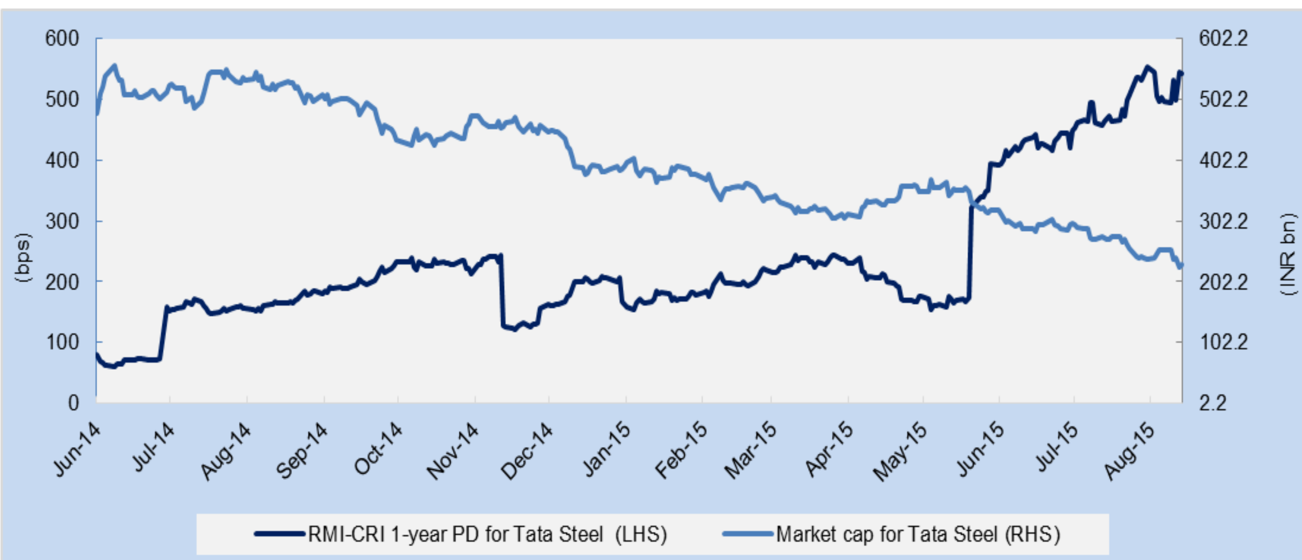

Figure 1: RMI-CRI 1-year Probability of Default and market cap for Tata Steel. *Source: RMI-CRI, Bloomberg*

The financial outlook of Tata Steel remains poor as sales, in the trailing twelve-month period, fell from INR 1,509.35bn in Q1 FY2015 to INR 1,320.64bn in Q1 FY2016. Operating profit, in the trailing twelve-month period, has also dropped from INR 110.07bn in Q1 FY2015 to INR 52.98bn in Q1 FY2016, which is consistent with the slowdown of demand in China's market.

3 Months Ending	Q1 FY2015 Jun 30, 2014	Q2 FY2015 Sep 30, 2014	Q3 FY2015 Dec 31, 2014	Q4 FY2015 Mar 31, 2015	Q1 FY2016 Jun 30, 2015
Sales (INR bn)	1,509.35	1,500.78	1,469.92	1,383.11	1,320.64
Operating profit (INR bn)	110.07	109.59	101.011	65.92	52.98

Table 1: Financial data for Tata Steel. *Source: Bloomberg*

The cash ratio of Tata Steel, which indicates the liquidity of the firm, has been on a general decline; it decreased from 0.34 in FY2011 to 0.22 in FY2015, implying a decline in the firm's ability to pay off short term debts and liabilities. The percentage of debt to equity, which indicates the amount of leverage that the firm takes on, is trending upwards, increasing from 166.38% in FY2011 to 244.01% in FY2015. Increasing liquidity and solvency risk coupled with a bearish steel market present a gloomy outlook for Tata Steel.

	FY2011	FY2012	FY2013	FY2014	FY2015
Cash Ratio	0.34	0.26	0.20	0.17	0.22
Debt/Equity (%)	166.38	135.66	191.03	192.98	244.01

Table 2: Financial data for Tata Steel. *Source: Bloomberg*

Despite the poor outlook for the steel sector, there is still some hope for Tata Steel. The low price of steel may possibly price out smaller competitors that produce at higher costs, thereby leading to a lower supply of steel and possibly higher steel prices in the future. Besides, the Indian government has increased the tariff on steel products imported into the country twice in the last three months, once in June and once in August. Those moves were made to mitigate the pressure on steel prices in India from imports and the share price of Tata Steel reacted positively to the news. The steel industry is currently in the bear market. However, steel prices will not stay low forever and market-correcting mechanisms are likely to eventually propel steel prices up. If Tata Steel is able to weather the storm, it should be able to see better days in the future.

Credit News

Anxiety over US student debt heightens

Aug 16. The US student loan market has expanded significantly in recent years, driven by rising tuition costs and high demand for a university education by millennials in the wake of the financial crisis. Total student debt in the US has trebled over the past decade to almost USD 1.2tn, sparking concerns that this constitutes a long-term threat to consumer spending by a core segment of the population and a drag on US economic growth. Slower repayment on some student loans has triggered credit rating reviews by Moody's and Fitch on USD 37bn and USD 8bn of student loan-backed bonds respectively. (FT)

Glencore's USD 31bn debt weighs on trader amid commodity rout

Aug 15. Commodity companies' earnings worldwide are under pressure because of 13-year-low prices, while industrywide dollar-bond borrowing costs have jumped to the highest in five years. Glencore Plc, the world's largest listed commodity supplier, may take further steps to alleviate the strain of a USD 31bn debt pile and protect its credit rating amid a rout in prices. The company has trimmed its spending plan as much as USD 800mn and sold USD 290mn of mines this year. According to JPMorgan, the company needs to cut net debt by almost half to USD 16bn by the end of next year to retain its credit rating. Glencore is rated BBB at S&P, the second-lowest investment grade. (Bloomberg)

Hercules Offshore files 'prepackaged' bankruptcy plan

Aug 13. Hercules Offshore, a global provider of offshore contract drilling and liftboat services to the oil and gas industry, filed for Chapter 11 bankruptcy protection today. The company filed for a "prepackaged plan" after nearly all of its senior bondholders voted in support to implement a USD 1.2bn debt-for-equity swap. Hercules Offshore held about USD 81mn in cash as of the filing date and, with the restructuring deal, it hopes to emerge out of bankruptcy by November 2015. Low oil prices, which resulted in customers cutting back on spending on offshore drilling, have resulted in many of the company's rigs being idled or sold at low prices when they failed to secure new contracts. (WSJ)

IMF gives cautious approval to China's new currency regime

Aug 12. The IMF has endorsed, albeit cautiously, China's move to win the reserve currency status for the Chinese Yuan (CNY). The recent devaluation of the CNY has been speculated as a move to increase the chances of including the CNY into the currency basket used to value IMF's de-facto currency. The IMF would decide later this year if they would include the CNY into the basket. One cause for concern is whether China would allow market forces to determine the value of the CNY. (FT)

Yuan devaluation worsens debt woes for local governments and companies

Aug 11. The recent devaluation of the Chinese Yuan is likely to adversely affect the local-government financing vehicles and Chinese companies which have borrowed overseas in foreign-denomination. Nicholas Zhi, a senior analyst at Moody's Investors Service, says that "it will hinder the development of the market and heighten the awareness of risk." There are also insufficient hedging mechanisms to mitigate the potential losses. However some analysts have stated that the impact of the yuan's devaluation on Chinese property firms has been reduced by the increase in funding alternatives. Alvin Wong, an analyst at Barclays Research, says that "It is definitely not a good thing, but I don't see an immediate hit to the property developers." (WSJ)

Japan economy shrinks in second-quarter (WSJ)

Yuan devaluation adds to metals-export competition (WSJ)

Westpac tightens interest-only credit policies (Sydney Morning Herald)

Regulatory Updates

EU may categorize short-term paper for capital treatment preference

Aug 14. In response to feedback from banks and asset managers, short-term asset-backed commercial paper may finally be eligible for preferential treatment in the Capital Requirements Regulation and Solvency II. The overhaul to the asset-backed securities was proposed by the EU chief of financial services, with an action plan already in the pipeline and a comprehensive package on the securitization further down the road. If enforced, the preferential regulatory treatment would go beyond the Basel group's criteria for "simple, transparent and comparable" securitizations, which were issued in July 2015. (Chicago Tribune)

FCA publishes rules on how it will apply the new accountability regime to UK branches of overseas banks and Solvency II firms

Aug 13. The Financial Conduct Authority (FCA), together with the Prudential Regulation Authority (PRA), published today near-final rules to apply a new accountability regime to the UK banking industry. The new regime would not only ensure that the senior managers can be held responsible for any misconduct within their areas of responsibilities, but individuals working at all levels would also need to maintain appropriate standards of conduct. Furthermore, the publication also covered near-final rules on the application of the accountability regime to foreign banks with branches in the UK. The latest changes aim to incorporate personal accountability in the culture of financial services and rebuild public trust. (FCA)

Capital injection key to Basel III transition of PSBs (The Economic Times)

Bank of England to look more closely at costs of financial regulation (Reuters)

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