Credit Research Initiative
NUS National University of Singapore | RMI Advancing Risk Management for Singapore and Beyond
transforming big data into smart data
Weekly Credit Brief Dec 01 - Dec 07

Mexico's largest corporate default in 20 years is on the horizon

by Dexter Tan

Empresas ICA SAB (ICA), Mexico's largest construction company, is on the brink of what could be the worst Mexican corporate default in two decades. Last Monday, the builder announced that it will use a 30-day grace period to pay its creditors, sending yields of its 2021 bond to 60%. ICA's payment failure could trigger a default on approximately USD 1.35bn in debt held by banks and bondholders around the world, making it the biggest bond default since the Tequila Crisis of 1995.

ICA's RMI-CRI 1-year Probability of Default (PD) of 703bps on Dec 4 was more than 16 times the median aggregate PD for 98 Mexican companies. The sharp gain in PD coincides with a 90% decline in market cap between Apr 2014 and Dec 2015.

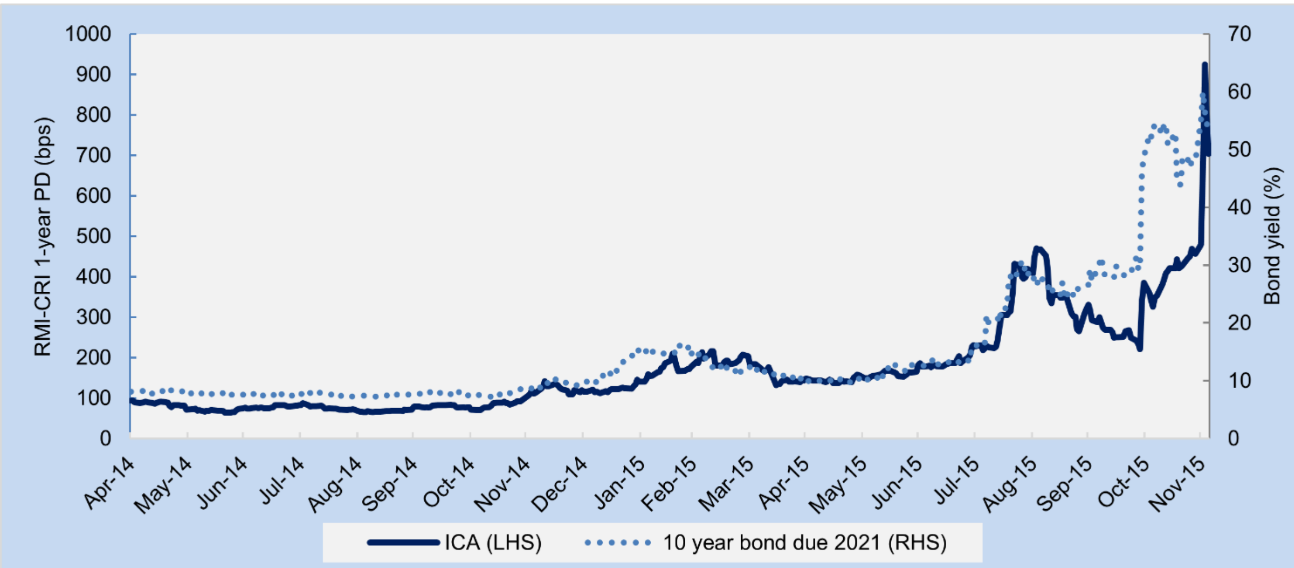

Figure 1: RMI-CRI 1-year PD for ICA and 10 year bond yield. *Source: RMI-CRI, Bloomberg*

The builder incurred losses of MXN 6bn in the first nine months of this year, which is double its net loss of MXN 3.02bn for the whole of 2014. In addition, ICA's interest coverage ratio (earnings before interest and taxes to interest expense) plummeted from 1.34X in Q1 2014 to 0.55X in Q3 2015.

The Mexican government's decision to cut infrastructure spending in January has hurt the company's credit profile. The firm was heavily reliant on public infrastructure project financing, which accounted for 90% of its trade and contract receivables. In their Q3 report, management said there was a lack of sufficient working capital resulting from delays in client payments in a number of Mexican construction projects. In the past, ICA accommodated client payment delays by incurring higher short term liabilities but it no longer does that because of the urgent need to improve its credit standing.

Secondly, ICA's creditworthiness deteriorated due to large FX losses from the depreciation of the MXN against the USD. As of Q3, 53% of ICA's debt was denominated in USD, while the majority of its revenues is denominated in MXN. Management blamed the 15% drop of the Peso against the Greenback as their chief contributing factor for the net loss in the first nine months of the year.

The immediate priority is to generate cash to pay short term and dollar denominated debt. On Oct 29, ICA hired Rothschild, a restructuring specialist, to improve its liquidity situation and long term prospects. The company managed to raise MXN 1.9bn of cash after selling some real estate and shares in Grupo Aeroportuario del Centro Norte. But Moody's thinks ICA could recover at least MXN 5bn from further asset monetization.

Coincidentally, ICA is facing the same situation it went through in 1998. The firm depended too much on government contracts and public work spending has been curbed because of weak oil prices. The market cap dropped more than 90% between 1998 and 2000, but recovered more than what it lost in the subsequent years. Will history repeat itself? Probably not. This time it's different as the company's leverage is significantly higher and a government bailout is not on the table.

Credit News

Aussie debt swells faster than global demand amid resources rout

Dec 6. Foreign holdings of outstanding Australian Federal debt slid to 63.6% in the September quarter, the least since 2009, official data show. The premium investors get to hold the debt instead of US notes of similar maturity was 66 basis points, well below the decade average of 152. The slowdown in China, Australia's largest trading partner, and the rout in iron ore, its chief export, looks set to extend the South Pacific nation's longest stretch of deficits since at least 1970. (Bloomberg)

Sovereign wealth funds withdraw USD 19bn from asset managers

Dec 6. In Q3, at least USD 19bn was being withdrawn by sovereign wealth funds from asset managers. Four of the five largest sovereign funds in the world are based in oil-rich countries and more than three-quarters of oil-backed vehicles outside of North America expect governments to withdraw money because of sustained low oil prices. If sovereign fund redemptions continue at the same pace as 2015, asset managers have to prepare for a bumpy ride in 2016. (FT)

ECB lowered stimulus ambitions after hitting opposition

Dec 5. European Central Bank (ECB) President and Chief Economists had aborted their earlier commitment last week of injecting the Eurozone with money, after the improvement in the Eurozone economic outlook and inflation forecasts. Policymakers were also concerned that a big move by the ECB would weaken the euro further and potentially impel the Federal Reserve to postpone its rate hike to prevent rapid divergence of policy between the world's top two central banks. The ECB cut its deposit rate on Thursday and extended its monthly asset buys by 6 month to boost low inflation and lift growth. These moves were considered by the market to be the bare minimum in light of the bank's previous signals. (CNBC)

Corporate debt downgrades hit USD 1tn of issues

Dec 4. More than USD 1tn of US corporate debt has been downgraded this year as defaults hit its highest point, since the global financial crisis. Analysts from the big three credit rating agencies have anticipated default rates to increase over the next 12 months, justifying the upcoming week to be an untimely period for Federal Reserve policymakers to tighten the monetary policy. Since the start of the year, about 102 companies have defaulted, including 63 in the US. In line with the widespread deterioration of firm's credit quality, bond prices have generally declined, while bond yields have increased accordingly. (FT)

India eyes clean energy at expense of coal

Dec 2. India, one of the world's largest coal users, may cut down its investments in the fuel. This decision depends on the funds India receives during the climate talks being held next week, to help it to shift towards utilizing cleaner sources of energy. According to a few activist groups, more than 500 global institutions with greater than USD 3.4tn in assets have pledged to reduce their holdings in fossil fuels. This is a significant improvement, relative to last year when 181 institutions with about USD 50bn in assets committed to this move. However, Benjamin Sporton, chief executive of the World Coal Association mentioned that the amount of money being pulled out of coal was actually relatively small, given that most of these large institutions have limited amount of coal holdings. (FT)

Beware this Chinese debt-fueled property-buying spree (WSJ)

Glencore to cut debt ahead of schedule (FT)

S&P again cuts scandal-hit Volkswagen's credit rating (Channel NewsAsia)

Regulatory Updates

Bank of England approves all UK insurers on capital calculations

Dec 6. The Bank of England passed all the British insurers that had applied to use their internal models to meet the Solvency II capital requirements. Insurers without the approved internal models will have to rely on the EU's standard calculations, which may require higher capital holdings. The Solvency II regime, which is intended to standardize insurance regulations in different European countries, will come into force in January 2016. (FT)

Leverage ratio for banks can rise as high as 5%, BIS says

Dec 6. According to research from the Bank for International Settlements (BIS), global regulators could raise the Basel III leverage ratio for banks to 5% without strangling credit supply. The debt limit helps to prevent damage to the financial system by containing the build-up of leverage. It also complements other capital requirements, further boosting resilience. Quantitative analysis by the BIS shows that the increase in leverage ratio, from its current level of 3%, is expected to result in more stability. (Bloomberg)

SEC to crack down on derivatives

Dec 4. US securities regulators, who feel lots of pressure to control potential risks in the asset management industry, are set to propose the restrictions on the use of derivatives in certain funds sold to the public. The move is expected to have an outsized effect on a small but growing sector that uses the complex instruments in an attempt to deliver double or even triple returns of the indices they track. Some regulators claim that these products, known as leveraged ETFs, can be highly volatile, and expose investors to sudden, outsized losses. (WSJ)

Fed weighs easing stress tests after plea from US banks (Bloomberg)

Hanergy link sours investor confidence in Chinese bank's IPO (WSJ)

Published weekly by Risk Management Institute, NUS | Disclaimer
Contributing Editor: Victor Liu