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Weekly Credit Brief December 30 - January 05

Billions of UK supermarket property writedowns loom

by Dexter Tan

The UK's largest listed supermarkets, Tesco, Sainsbury and WM Morrison, are poised to write off billions of property value collectively ahead of their business rate revaluations. Commercial property in Britain is valued every five years and this forms the basis for calculating business rates. Tesco is expected to write off at least GBP 1bn of its property portfolio while WM Morrison and Sainsbury have reported more than GBP 1bn of impaired assets last year. The firms will report their festive sales this week and it is expected that Tesco will use Thursday's trading statement to outline their capital raising and cost cutting measures.

The supermarkets have expanded too quickly by acquiring large land banks to make room for future expansion and secure market share by stopping the competition from doing so. Now, majority of the development land owned by the supermarkets is lying idle and firms are starting to cancel expansion plans and write down unprofitable existing stores. The write-offs have hit the firms' bottom lines in a weak market. The RMI 1-year probabilities of default (RMI 1-year PD) for these firms have increased since 2013, in tandem with lower market capitalization and declining sales. WM Morrison reported a property-related charge of about GBP 700mn in March while Sainsbury took an impairment charge of GBP 628mn after a review of its property portfolio.

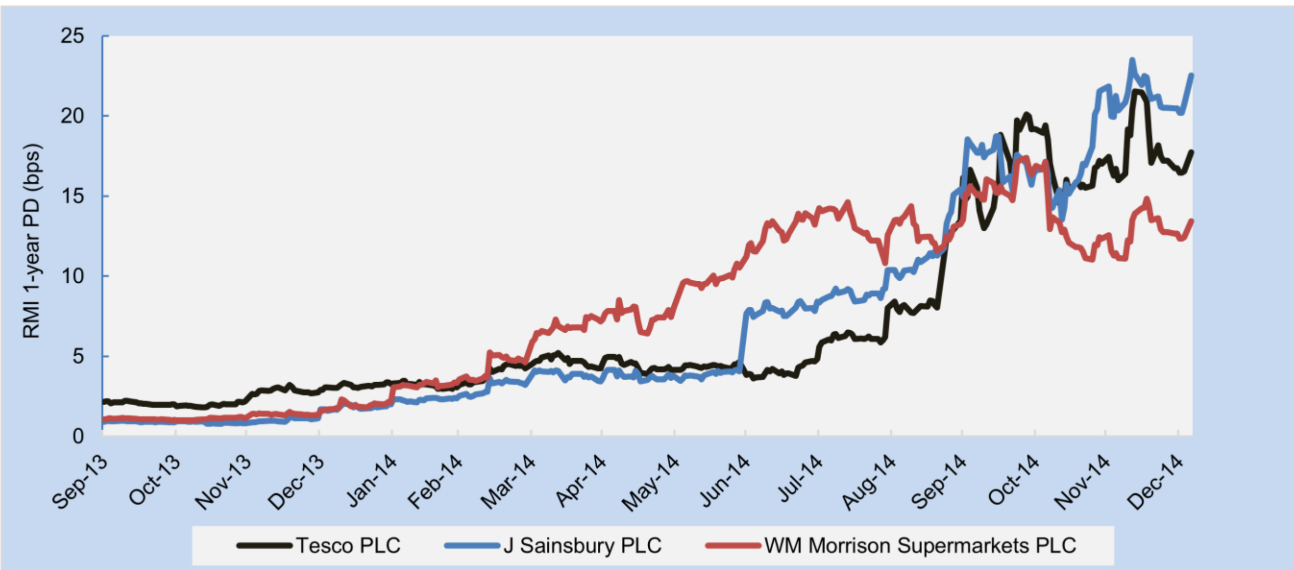

Figure 1: RMI 1-year PDs for UK supermarkets. *Source: Risk Management Institute*

The weaker credit profiles are a reflection of other performance metrics which also point to deteriorating creditworthiness. For example, the net debt to EBITDA (earnings before interests, taxes, depreciation and amortization), indicating the degree to which a firm has borrowed against its future operating earnings, has increased for all 3 companies during 2014. A higher multiple suggests a longer period of operating profit would be required to repay its debt. A measure of the company's financial flexibility - retained cash flow to net debt has mostly declined in the same period. It indicates how quickly debt could be repaid with cash flow after dividends are paid. Retained cash flow, by itself, measures the firm's ability to cover its working capital, maintenance capital expenditures and investment spending needs. All 3 companies have positive retained cash flows in the latest 6 months with the exception of Tesco with a net GBP 19mn outflow.

In addition, the level of default risk for the 3 abovementioned firms could possibly rise if the present values of their future rental costs are classified as liabilities. These future liabilities are off balance sheet, but they will increase the reported leverage ratios considerably if they are factored into current calculations. For instance, Morrison's Net debt to EBITDA ratios could increase if the future minimum operating lease obligations in FY 2014 and FY 2013 of GBP 1.3bn and GBP 1.0bn were considered.

	WM Morrison		Tesco		Sainsbury	
	Six months ending		Six months ending		Six months ending	
	03/08/2014	02/02/2014	23/08/2014	22/02/2014	27/09/2014	15/03/2014
EBIT	229	427	340	1387	431	426
Net Debt / EBITDA	161%	161%	277%	172%	109%	81%
T12m Retained Cash Flow to Net Debt	17%	16%	19%	28%	29%	53%
Revenue	8496	8742	30473	31643	12667	11265
Retained Cash Flow	253	192	-19	1766	182	281
	FY 2014	FY 2013	FY 2014	FY 2013	FY 2014	FY 2013
Future Minimum Operating Lease Obligations	1339	1005	15276	16404	8812	8316

Table 1: Financial performance metrics for UK firms, measured in GBP mn unless otherwise stated. Future minimum operating lease obligations are Bloomberg estimates for the following 5 years. Source: *Bloomberg, company reports*

In 2014, Tesco was involved in an accounting scandal which led to the suspension and exit of several executives at the firm. The company said that the profit guidance of GBP 250mn for 1H 2014 was too high, as it had overstated the rebate income it would receive from suppliers. The UK Serious Fraud Office started a criminal investigation into the figures and the company's reputation has been suffering since then. The problem relates to extra incentives that Tesco receives from suppliers for hitting a fixed amount of sales, or support for its promotions. Supermarkets must estimate halfway through the year how much the incentives/rebates will be for the full year. The scandal has brought attention to the lack of transparency over supplier payments from retailers and the common practice of commercial income which has been widespread across the industry for decades. Sales at Tesco's UK locations have dropped and its suppliers have shifted support from Tesco to competitors that are growing.

The UK grocery market is facing mounting pressure from growing discounters such as Aldi and Lidl. British retailers are turning to online and local convenience stores for grocery shopping which has resulted in weakening sales and severe price pressure in the UK grocery market. According to Kantar Worldpanel, the amount spent in major grocery stores decreased 0.2% in the 12 weeks to November 9, which is the first decline since data was collected twenty years ago. Retailers have cut prices aggressively to attract shoppers who are moving away from the large, out of town supermarkets which are the primary revenue channels for the companies. Although the large supermarkets have their online presence, the growth of online sales will mostly come from the self-cannibalization at the retailer level and incur additional costs for the firm. Smaller players with a pure online business model are able to grow faster with lower costs and take away market share from the brick and mortar incumbents.

Credit News

Caesars swaps ruling heads to arbitration panel, ISDA says

Jan 6. An arbitration panel will rule on whether a USD 26.9bn worth of credit-default swaps linked to Caesars Entertainment Corp. should be settled after a committee of bond traders failed to make a decisive decision. Five members out of the 15-firm panel voted in favor of payouts to be triggered, including Elliott Management Corp., which is said to have bought swaps betting on a Caesars default. According to ISDA, a panel of three independent third-party professionals consisting of academics or legal experts in the derivatives market will make a binding decision after an arbitration-style review. The outstanding swap is estimated at a maximum payout of USD 1.7bn, according to the Depository Trust & Clearing Corp. (Bloomberg)

China developer Kaisa says fails to repay USD 51mn loan, may default on others

Jan 2. Chinese property developer Kaisa Group Holdings said it had failed to repay a HKD 400mn (USD 51.3mn) loan and warned it may default on more debt, the latest problem to hit the firm amid a downturn in the real estate sector. The failure to repay the HSBC term loan may trigger default on other loan facilities, debt and equity securities, co-chairman Sun Yuenan said in the filing to the Hong Kong exchange. Last month, Kaisa said the Chinese authorities had imposed a sales blockage on some its projects in the southern city of Shenzhen. Moody's downgraded its credit rating to B3 from B1, warning of further cuts, and Standard & Poor's said its sales and operations could be "significantly affected" over the next year. (Reuters)

Surging US dollar burns emerging markets

Jan 1. The soaring US dollar is squeezing companies in emerging markets on roughly USD 1.2tn in bonds sold to investors before the greenback's surge. According to reports, the US dollar is on track to gain more than 7% compared with a group of EM currencies, making regular bond payments more expensive and reducing earnings. This evokes memories of previous currency crises, and companies may start to mitigate losses by moving to issuing bonds denominated in local currencies, or forced to dip into reserves, which may trigger defaults on corporate bonds. More pressure is expected to follow, if the Fed raises interest rates this year for the first time since 2006. (The Australian)

Singapore alert to risks as cracks emerge for junk (Bloomberg)

Macau prospects unpredictable as coin toss as views clash (Bloomberg)

Slow China growth, uneven global recovery hampers Singapore's economy (Bloomberg)

Russia throws lifeline to companies starved for cash by sanctions (CNN)

Regulatory Updates

UK financial watchdog doubles interventions

Jan 4. In 2014, Financial Conduct Authority, the UK's financial watchdog, stepped into company practices more than twice as frequent, by 31 so-called early interventions without a lengthy official investigation compared with 14 in 2013. Twelve of them were about financial-crime issues such as money-laundering. It was said more proactive than its predecessor, the Financial Services Authority, with a stronger mandate for protecting customers, as it has pledged as a more interventionist regulator. However, it is also facing criticisms of being over rigorous. (FT)

CFPB sets sights on payday loans

Jan 4. For the first time, the Consumer Financial Protection Bureau is writing rules for payday loans, as a response to concerns that the short-term, high-rate debt can trap consumers in a borrowing cycle beyond they can pay. Payday loans are typically less than USD 500mn. Borrowers provide a lender with a personal check dated for the next payday or permission to debit their bank accounts two weeks later, with a finance charge added. The bureau is exploring to require payday lenders to ensure loans paid by customers, and seeking to establish the first federal regulations for the industry of USD 46bn, which was originally overseen by states. (WSJ)

Financial regulator vows to control household debt (Korea Herald)

British banks to outline plans to protect ordinary customers (TODAY)

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