



## Brexit woes hamper Capita PLC

By [Samuel Chee](#)

Capita PLC, the leading provider of Business Process Management (BPM) in the UK, has received bad press as of late due to discouraging financial results. Forecasts have been pessimistic especially with lingering Brexit woes affecting business confidence, [leading to a "belt-tightening"](#) which saw its clients cut their spending. Capita was the first to bear the brunt and reported a 54% drop in number of major contract closed for the first half of 2017 as compared to that of the year before. Investors were quick to react, resulting in Capita's market capitalization plunging by approximately 43% within the last six months.

Brexit is proving to be a huge contributor to the company's troubles. Before stepping down as Chief Executive, Andy Parker cited that one of the biggest challenge Capita faced was the [uncertainty of when Brexit-caused effects will eventually come to an end](#). Companies in the private sector are currently deterred by market volatility which would very well cause a drop in the number of contracts available. Capita's pipeline of bidding for future work has already fallen from [GBP 3.1bn in Q3 2017 to GBP 2.5bn](#) at the end of 2017. Unless business confidence picks up, Capita's revenue from the private sector will continue to be negatively affected.

Beside new contracts, Capita has also been far from effective in keeping contracts. In particular, Capita was [dropped by M&G Prudential](#) as its pension administrator, losing a contract that is worth about GBP 80mn in revenue for 2017. On the public sector front, Capita had its contract with the UK's Ministry of Defense [terminated earlier than expected](#), halving the contract period from 10 years to 5 years. Capita's inability to keep hold of high-value contracts is a cause for concern, especially given that the company's operating margin saw a declining trend over the last 2 financial years (see Table 1).

	2015 S1	2015 S2	2016 S1	2016 S2	2017 S1
<b>Net Debt/Equity (%)</b>	246.33	302.31	348.18	475.07	-
<b>Operating Margin (%)</b>	7.43	1.43	4.05	-3.55	2.94
<b>Quick Ratio</b>	0.22	0.44	0.39	0.66	0.32

Table 1: Financial Data for Capita PLC. Source: Bloomberg

Internally, Capita is currently undergoing a major restructuring plan. According to its FY16 Annual Report, the company commented on plans for the disposal of several business units in the near future so as to pave way for structural changes. This reflects the management's demand for a more streamlined operation after a slew of acquisitions over the past years. These acquisitions, strategic or not, increased the leverage of the company, leading to an increase in total debt amounts as well as a higher net debt-to-equity ratio (see Table 1). While it seems to be a [common practice in the industry to acquire smaller players](#), the acquirer may not have sufficient expertise to integrate them. This strategy seems to be backfiring on Capita - especially when debts resulted in Capita turning in a historically low quick ratio in 2015 S1 after aggressive acquisitions during 2013 and 2014. Capita is unable to fully take advantage of these acquisitions, with the company identifying its weakness in acquisitions as one of its core risk elements disclosed in its financial statement. Failure to generate anticipated revenues and synergies makes these acquisitions even less justified.

Whilst Capita attempts to cut off certain business units, we may observe a further buildup of write-offs for impairment losses as well as losses on disposal, all of which harm Capita's financial position. Implementing structural changes is a lengthy and costly process and as of date, Capita has already incurred close to GBP 200mn in restructuring expense which is set to increase further in the future.

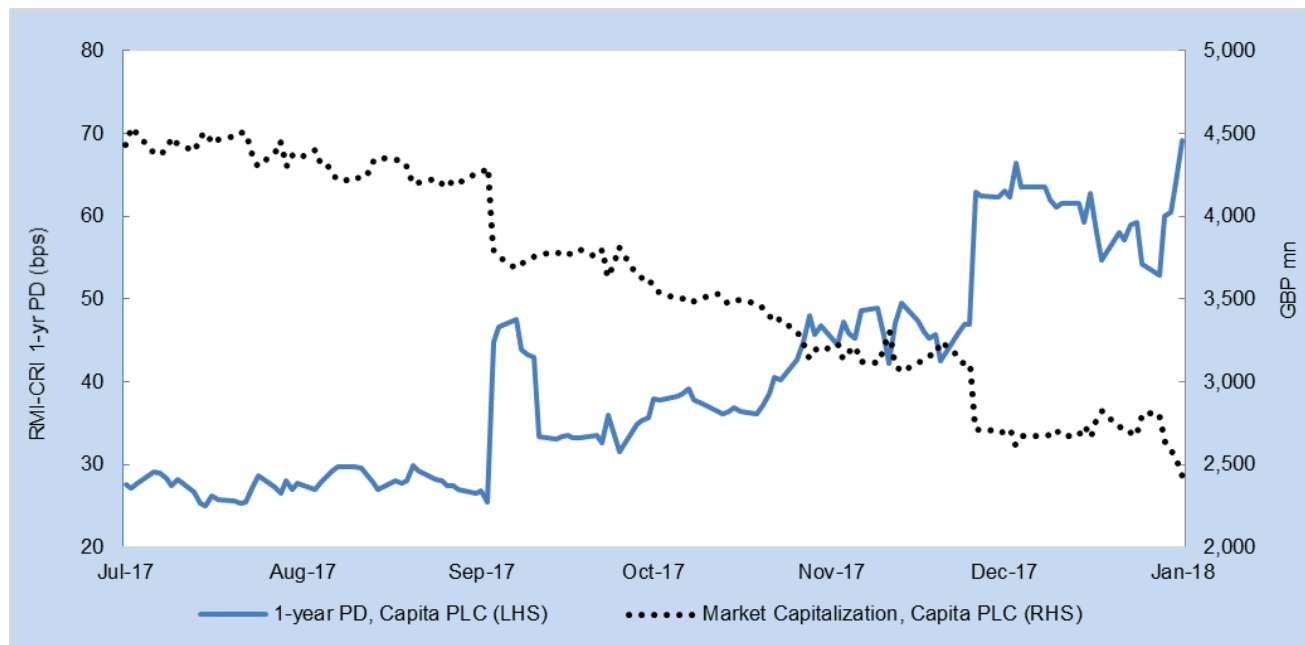


Figure 1: RMI-CRI 1-year PD for Capita PLC (LHS) & Market Capitalization for Capita PLC (RHS). Source: RMI-CRI, Bloomberg

In light of the troubles Capita faces, the RMI-CRI Probability of Default (PD) shows a significant increase over the past 6 months (see Figure 1). Recent news regarding the loss of major contracts has been a massive factor for the spike as the market capitalization fell. Capita's quick ratio has fallen to its lowest figure since 2015, signaling a drop in liquidity and credit-worthiness (see Table 1).

Speaking of bad press, Capita has further harmed itself with news of the company's plan to cut cost by modifying its current defined pension scheme. This attempt to lower its pension liabilities faced [immense protest from pension savers](#) to the extent that work unions got involved. With the recent collapse of Carillion PLC largely due to its [huge pension deficit involved](#), pension schemes have come under huge scrutiny in the UK. With the strong unions and hostile rejection from pension savers, Capita might not succeed in tweaking its pension scheme and have to continue carrying the financial burden it entails. As such, Capita needs to be prudent so as to avoid racking up a huge deficit and prevent a situation similar to Carillion.

Moving forward, Capita will be exposed to challenges brought upon by policy changes within the UK. The [public sector in the UK faces budget cuts](#) which is already in effect up till 2020, potentially decreasing the pipeline of contracts from the public sector. The [minimum wage is also set to increase](#) as announced in the 2017 Budget which will see a rise of 4.4% to a wage rate of GBP 7.83 per hour. With human capital being a key part of its operation, employee wages and salaries account for more than half of Capita's cost of sales. A rise in wage rate will drive up cost and thin off future profit margins. Capita will have to find a way to navigate through these unexpected policy changes so as to generate enough revenue to service its debts and provide for its internal restructuring plans.

## Credit News

### Iran's financial sector faces asset quality risks and capital erosion

**Jan 21.** According to the Institute of International Finance (IIF), unstable public finances of Iran are causing capital erosion and deterioration in asset quality of banks. Indeed, poor management and sanctions over the past few years have led to a sharp increase in non-performing loans (NPL) ratio to 13% and a decline in capital adequacy ratio to slightly less than 6% in 2017. In the same year, total debt owed by state and private banks increased by more than 25% YoY to USD 340bn, increasing the risk of forcing large write-offs in the future. Consequently, domestic banks are likely to face a slowdown, while international banks are cautious about doing business in Iran, as US dollar clearing restrictions remain and pose a major challenge for global banks to re-establish correspondent banking relationships. ([Gulf News](#))

### US banks suffer 20% jump in credit card losses

**Jan 21.** The largest four banks in the US have reported a combined loss of USD 12.5bn from bad credit card loans, about USD 2bn more than a year ago. Analysts forecast that bad credit card loans could climb to 4.5% of receivables this year, up from 2.92% in 2015. Banks like Citigroup, JP Morgan Chase, Bank of America and Wells Fargo however are still keen to issue cards to consumers as the return on credit card lending of 4% exceeds the 1.4% return for retail banking. Lenders collect fees from vendors for every transaction and typically charge customers interest fees as high as 13% for every late repayment. ([FT](#))

### Dalian Wanda pledges to clear overseas debt as revenues drop

**Jan 21.** Dalian Wanda Group, a Chinese developer-turned-entertainment conglomerate, has seen its revenue drop for the second year in a row, triggering a pledge from its chairman Wang Jianlin to "clear all overseas debt". Meanwhile, greater scrutiny over its financial health continues to hit earnings. Group-level operating revenue dropped to 10.8% in 2017 from the year before to RMB 227.37bn, largely due to the sale of some of the group's core hotel and theme park assets. After China's bank regulator ordered domestic lenders to assess "systemic risk" posed by Dalian Wanda and other conglomerates, Dalian Wanda sold many of its prized assets, including the USD 82mn sale of luxury property in London last week and other overseas properties. Rating agency S&P Global lowered Dalian Wanda Commercial Properties, Wanda's primary subsidiary, to junk status last September over concerns of existing debt repayment. ([FT](#))

### Chinese region's fake data in focus after local borrower downgrade

**Jan 19.** Fitch Ratings cut Inner Mongolia High-Grade Highway Construction and Development Company (HGHC)'s long term foreign and local currency issuer default rating to BBB- from BBB. HGHC is a local state-owned company in China's Inner Mongolia, a region that recently admitted having inflated key economic data. The price of HGHC's USD 400mn three-year bonds experienced the biggest decline of 0.4% since issuance last year. Inner Mongolia revised down its 2016 general public budget revenue by 26% and cut its 2017 general public budget revenue guidance by 17%. Investors are growing more concerned about local credit risks as the government steps up efforts to curb leverage. Fitch said the downgrade also takes into account the weak internal governance in the Inner Mongolia region. ([Bloomberg](#))

### Global defaults, spreads to rise amid central bank concerns

**Jan 18.** According to the International Association of Credit Portfolio Managers' (IACPM) quarterly survey, interest rates and defaults are likely to increase, as many central banks are supporting the case for a tighter monetary policy. The Federal Reserve, for example, may raise rates three times this year as the economic growth and inflation expanded at a modest to moderate pace. The IACPM's 12-month Credit Default Outlook Index indicated credit erosion with wider spreads and increased defaults for issuers in all regions. The least negative outlook is for European credit issuers, as the ECB remains accommodative. ([Reuters](#))

**Philadelphia Energy Solutions to file for bankruptcy** ([Channel NewsAsia](#))

**Appetite for junk bonds sparks exposure warnings** ([FT](#))

**Pacific Radiance offers noteholders debt-to-equity swap, two coupon payments** ([Business Times](#))

## Regulatory Updates

### Carillion collapse prompts rules on UK corporate recklessness

**Jan 21.** In response to Carillion's collapse, UK Prime Minister Theresa May pledged new rules to deal with reckless corporate culture that put short-term profits ahead of long-term success. The new rules could include punitive fines for directors, or giving regulators the power to block takeovers that risk pension pots. Theresa May reiterated her commitment to greater transparency over corporate pay, and to a requirement that companies explain how they take their staff's interests into account. ([Bloomberg](#))

### Fed working on proposal to ease up on bank leverage limits

**Jan 19.** The Federal Reserve (Fed) is working to relax a key part of post-crisis demands for drastically increased capital levels at biggest banks, a move that could free up billions of dollars for some Wall Street giants. Central bank staffers are rewriting the leverage ratio rule to better align with a recent agreement among global regulators. According to some people who requested anonymity, while the Fed effort is drawing opposition from the Federal Deposit Insurance Corp, work on the proposal is proceeding quickly at the Fed and it could represent an easier path for banks to win relief than relying on a politically divided congress to pass legislation revising the leverage ratio. The Treasury Department has also suggested in a June report that Wall Street should get a break on some parts of the requirement. ([Bloomberg](#))

### Accounting rules to hit SEB balance sheet ([FT](#))

**Philippines central bank increases leverage ratio** ([Securities Lending Times](#))

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