Credit Research Initiative
Risk Management Institute, National University of Singapore
NUS National University of Singapore | RMI Advancing Risk Management for Singapore and Beyond
transforming big data into smart data
Weekly Credit Brief Jun 12 - Jun 18

Gogo Inc's credit outlook worsens after ZTE USA Inc setback

By Lin Li

Gogo Inc (Gogo), a leading in-flight service provider based in the US, is struggling with high leverage, negative cash flows and increased competition. The company specializes in building online aircraft systems and offering wireless digital entertainment to the aviation industry, making internet connectivity possible in flight. After the US banned ZTE USA Inc from supplying essential components to Gogo in April, the market capitalization of the in-flight service provider had dropped by more than 40%. The RMI-CRI 1-year Probability of Default (PD) for Gogo surged past 200bps over the past two months, which is significantly higher than its main competitors, indicating a deteriorated credit outlook for the firm.

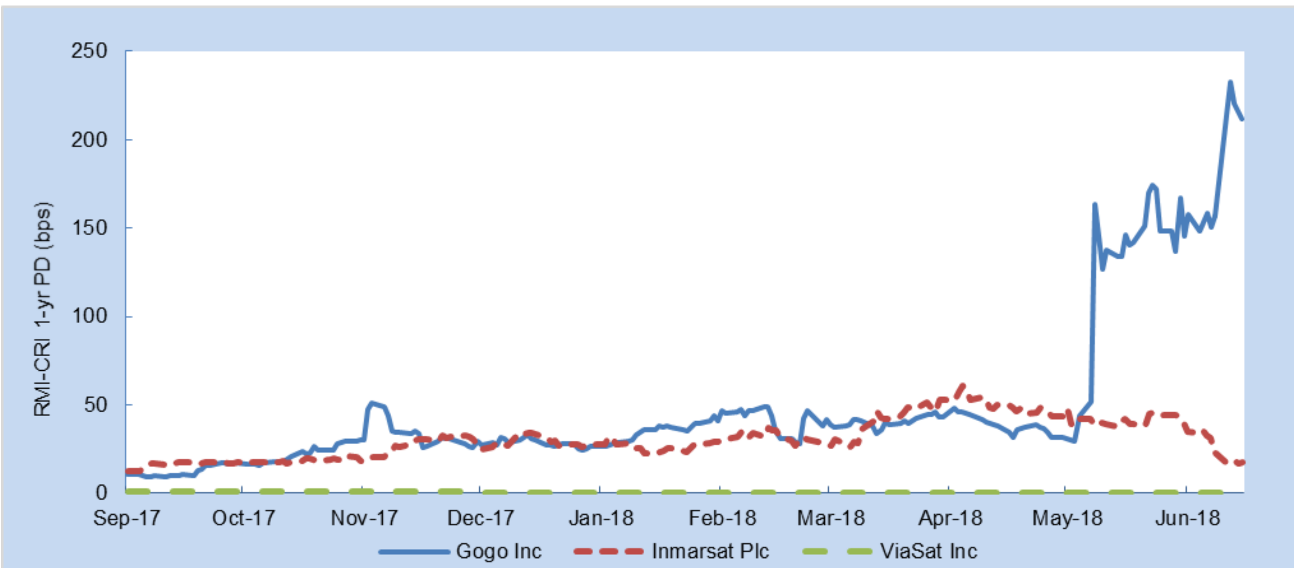

Figure 1: RMI-CRI 1-year PD for Gogo Inc and its main competitors: Inmarsat Plc and ViaSat Inc. *Source: RMI-CRI*

Gogo's debt financed investments resulted in a deterioration of cash flow and a material increase in leverage. After embarking on new 2Ku satellite solution installations last year, the company's heavy spending in capital expenditure resulted in negative cash flows in 2017. According to Moody's, the adjusted EBITDA margin for the first quarter of 2018 was about 5%, down by almost 1.5 percentage points from the prior year's quarter. According to Bloomberg, Gogo's Total Debt over Total Book Assets ratio climbed to 77% by the end of Q1 2018, exceeding the average of 41% from its main competitors: Inmarsat Plc and ViaSat Inc. Furthermore, Gogo indicated that their earlier EBITDA profit target range of USD 75mn to USD 100mn would be unreachable this year. The lowered EBITDA target is based on increased operating costs and lost sales due to reliability challenges around the new 2Ku network systems. Gogo Inc.'s market capitalization plunged 9% after withdrawing the earnings forecasts.

	Q3 2017	Q4 2017	Q1 2018
Adjusted EBITDA	22.1	35.7	35.4
Total Debt/Total Assets (%)	73.2	71.4	77.5
Net Debt/Capital (%)	136.1	147.7	137.0
Trailing 12-month Adjusted Net Income	-151.0	-169.2	-155.3
Trailing 12-month Free Cash Flow	-216.0	-192.1	-217.5

Table 1: Financial metrics for Gogo Inc. EBITDA and net income adjusted based on Bloomberg estimates. Free Cash flow defined as the difference between operating cash flow and capital expenditure. Information in USD mn, unless indicated otherwise. *Source: Bloomberg*

Gogo Inc. largely depends upon third party suppliers to manufacture and maintain in-flight equipment. Many of these suppliers are single-source providers because of intellectual property. In April, the US Commerce Department's Bureau of Industry and Security issued a denial order that prohibits China-based affiliates of ZTE

USA Inc (ZTE) from directly or indirectly participating in any transaction involving certain technology exported from the United States. As mentioned in the Q1 earnings release, Gogo and ZTE have been longtime partners since 2008. ZTE has developed, supplied and supported the base stations and associated core network elements used in Gogo's current Air-To-Ground (ATG) network, which is the basis of Gogo's Business Aviation (BA) market. According to Bloomberg, the BA segment made a profit of USD 32.3mn while the Commercial Aviation segment suffered a loss of USD 22.6mn during Q1 2018. Gogo's profitability would be adversely influenced if ZTE does not continue the contract.

In addition, ZTE is developing and has agreed to supply for Gogo's ATG-Next Generation (NG) network. Gogo has incurred material operating and capital expenditures for the development work of the ATG-NG network with ZTE's participation. If ZTE is unable to continue as a supplier of the network, Gogo may have to face sunk costs and find alternative suppliers, possibly delaying the project and affecting the operating efficiency of the firm. It remains unclear what the US government or foreign governments will or will not do with respect to tariffs or other international trade agreements and policies. A trade war or other governmental action related to tariffs has the potential to adversely impact Gogo's supply chain and foreign demand for their products and services.

Although Gogo dominates the US inflight connectivity (IFC) market with an approximate 50% market share of US commercial aircraft, Gogo still faces fierce competition. Its competitor ViaSat Inc beat Gogo and won a contract to equip American Airlines' new fleet aircraft with satellite internet access last year, causing Gogo's stock to plummet by 16%. With a 25-30% market share of commercial aircraft worldwide, it may be difficult for Gogo to maintain existing contracts and capture additional aircraft contracts among the main IFC rivals including Inmarsat Plc. According to JP Morgan estimates, competitors like Thales and Panasonic may cut pricing in order to maintain shares, which will make Gogo's already high pricing less attractive. As more contracts come up for renewal, Gogo could see incremental pressure on its overall market share.

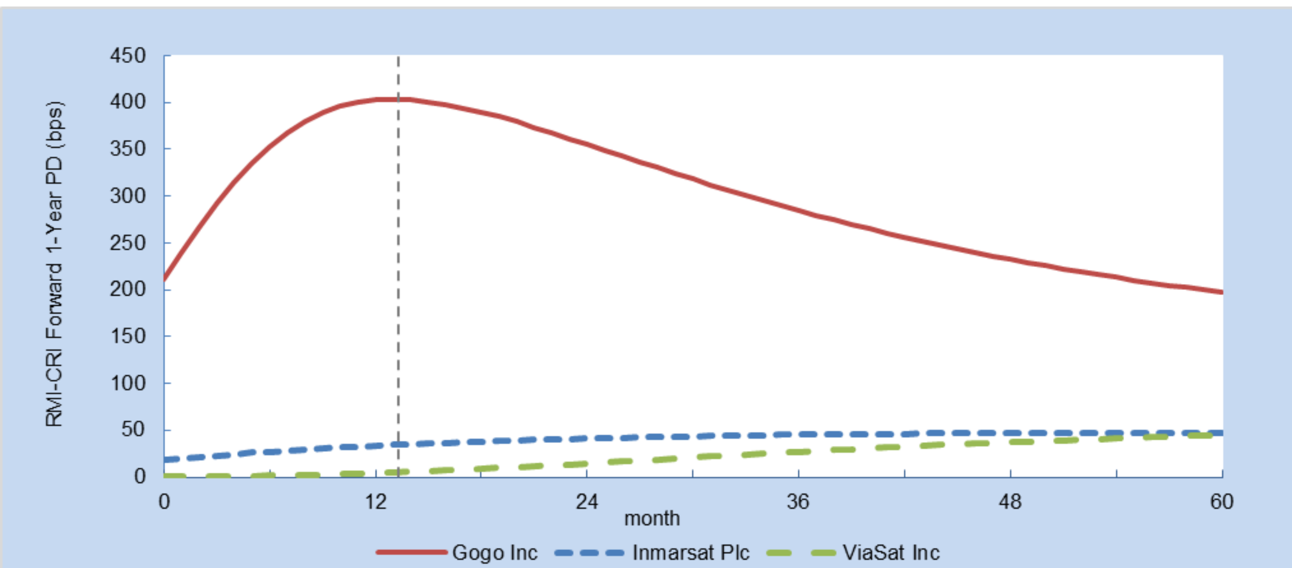

Figure 2: RMI-CRI Forward 1-year PD term structures for Gogo Inc and its competitors: Inmarsat Plc and ViaSat Inc on June 15, 2018. *Source: RMI-CRI*

A declining cash balance would likely impair Gogo Inc's liquidity profile into 2019. More importantly, Gogo faces USD 362mn of convertible notes due on March 1, 2020. Another USD 690mn callable bond will mature in 2022. Moody's predicts the firm's cash flows will not sustain adequate liquidity beyond the next 17 months and downgraded the firm to Caa1. The lowered rating may further affect the company's ability to refinance or secure additional funding sources.

As shown in Figure 2, the RMI-CRI Forward 1-year Probability of Default (Forward PD) term structure for Gogo steepens with time to peak in about a year and then decreases, suggesting that based on the market information available as of June 15, 2018, Gogo's default risk is likely to continue increasing in this year while the credit risk of its competitors remain relatively low. Intuitively, the Forward PD computes the credit risk of the firm on a future period, which works like a forward interest rate. For instance, the 3-month forward 1-Year PD is the probability that the firm defaults during the period from three months onwards to one year plus three months, conditional on the firm surviving the next three months. If Gogo is able to improve its cash flow over the next twelve months and find an appropriate supplier for its ATG network in time, its credit profile could marginally improve.

Credit News

1MDB scandal turns funds cool on Malaysia

Jun 18. The recently disclosed scandal around the troubled state investment fund 1MDB has turned bond fund investors away from Malaysia. After the disclosure of the nation's debt being 60% higher than the estimates at USD 250bn, mainly because of the hidden liabilities of the fund, almost all of the big investors have cut their holdings in the state investment bond fund. In its monthly report, Brown Brothers Harriman stated that the rating agencies are likely to downgrade Malaysia if its fiscal health deteriorates due to the liabilities arising from 1MDB. Established in 2009 under former PM Najib Razak, the fund had been plagued by heavy debt burden and questionable investment decisions which led to a global probe in alleged embezzlement and money laundering. After the debt disclosure, the ringgit slid to a five month low against the US dollar and overseas ownership of Malaysia's bonds dropped to the lowest since August. (Bloomberg)

Wall St banks sign up to new platform to underpin bond revenues

Jun 17. Wall Street top banks club together to maintain its influence on the lucrative market for debt issuance through bond market digitalization. Recently, the top three debt underwriters: JPMorgan, Citibank, and Bank of America are developing a new bond platform which aims to improve the technology used in the sale of bonds. Goldman Sachs, Wells Fargo, BNP Paribas, and Deutsche Bank are also joining the initiative, making it six out of top ten debt underwriters now being involved in the consortium. The platform will be used to announce new bond sales, communicate pricing information with investors, share credit ratings, prospectuses, term sheets and other documentation, process investor orders and ultimately allocate bonds to would-be buyers. The banks are planning to create both an API that can plug into their clients' order management systems, as well as develop a web or cloud-based program. The new system should deliver cost-savings and reduce the strain on the workforces (FT)

China's debt crackdown helps revive flagging Dim Sum market

Jun 15. Sales of Dim Sum bonds, which are CNY-denominated notes issued offshore reached USD 8.5bn in 2018, 17% higher than the peak in 2017. The increase in sales reverses a three-year downtrend as authorities slow down the pace of approval of onshore borrowing and crack down of shadow banking activities. The Chinese Yuan is one of the top-performing emerging-market currencies against the US dollar this year, which makes Dim Sum bonds more attractive to investors. According to analysts, the number of bond issuance is expected to continue rising in the second half of this year. (Bloomberg)

Embattled ZTE seeks USD 10.7bn credit line, nominates 8 board members

Jun 14. ZTE Corp, China's second largest telecom equipment maker, proposed a USD 10.7bn financing plan and nominated eight new board members on June 13. The move indicates that the company is working towards meeting conditions brought up by US government to resume its business with American suppliers. Earlier in April this year, the US imposed the seven-year supplier ban on ZTE for breaching the US embargo on trade with Iran and North Korea. To end the ban, ZTE was asked to overhaul its management team, hire a US-appointed special compliance coordinator, as well as, pay a USD 1bn fine, which ZTE has agreed to pay on June 8. On the other hand, ZTE proposed to allow the board to apply for a USD 10.7bn credit line, of which USD 4.69bn will be provided from the Bank of China and USD 6bn from China Development Bank. ZTE also proposed to remove a clause that required the chairman to be elected from directors or members of the senior officers of the company who had served for more than 3 years. (Reuters)

L&G strikes pensions and loan deal with Heathrow

Jun 14. Legal & General (L&G) has signed a novel pensions deal with Heathrow Airport, in which it has agreed to lend money to the company and at the same time take on some of its pension promises. According to the deal, L&G will take on GBP 325mn of pension promises and lend the airport GBP160mn via a bespoke, unlisted corporate bond. This bond price is linked to inflation and hence allows the insurer to cut the price of the buy-in deal. The coupon rate was not disclosed but, according to Phil Wilbraham, chairman of the trustees, this deal will de-risk the position of the scheme members and enable Heathrow to strengthen its financial position ahead of its airport expansion plan. These types of buy-in and buyout market trades are expected to grow this year. With the new pension consolidation vehicles saying that they can allow companies to pass on their pension promises more cheaply than they could with an insurer, a possible threat looms over the market. (FT)

AT&T cut by Moody's as Time Warner deal adds billions of debt (Bloomberg)

Rolls-Royce cuts 4600 jobs at 'pivotal moment' for business (Reuters)

China's embattled HNA shuts Hong Kong unit as it struggles to repay debt (SCMP)

Regulatory Updates

Kenya will repeal interest-rate cap that curbed bank lending

Jun 14. Kenya plans to repeal section 33B of the Banking Amendment Act which caps commercial interest rates at 400bps. The amendment was introduced in August 2016 and exacerbated a slump in credit growth to the private sector, which fell from 13.5% before the law was introduced to 2.8% in April 2018. The ceiling on the cost of loans have nullified Kenyan banks' ability to price risk and failed to increase credit. Mixed responses were raised against the plan to repeal the interest rate cap. While the parliament opposes the repeal, the Kenyan Bankers Association welcomed the repeal as they believe that it will increase financial access and economic growth by enhancing credit. (Bloomberg)

Fed raises key interest rate to 1.75-2%, signals 4 rate hikes in 2018

Jun 13. The US Federal Reserve raised the benchmark lending rate on June 13 bringing the federal funds rate to a range of 1.75-2% in the second increase of the year. The reserve also signaled two more hikes in 2018 and four in 2019, a sign that the central bank could be concerned about accelerating inflation. This increase is a response to rising prices but is likely to surprise markets, as most economists did not expect the Fed to give a clear sign that an additional rate increase was likely until later in the year. However, the Federal Open Market Committee (FOMC) also claimed that the raising interest rates were unlikely to derail economic growth, which has been characterized as 'strong' rather than 'moderate'. The inflation index is currently at 2% but other measure of consumers and producer prices have increased due to an increase in crude oil prices and metals prices, as a result of steep import tariffs imposed by the US President. In addition, the record low unemployment rate is projected to fall further to 3.6% by the end of the year. (Straits Times)

Asian central banks pressured to follow US rate hikes (Nikkei Asia)

ECB to end bond-buying program in December as crisis-era policies wind down (WSJ)

Published weekly by Risk Management Institute, NUS | Disclaimer
Contributing Editor: Dexter Tan