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Hertz and Avis struggle in competitive car rental market

by Dexter Tan

The rising popularity of Uber and Lyft may be shifting the attention of short sellers to car rental companies such as Hertz Global Holdings (Hertz) and the Avis Budget Group (Avis). According to Certify, the second largest provider of travel and expense management software in North America, Uber accounted for 43 percent of US road transportation transactions, overtaking car rental companies for the first time in Q4 2015. The software provider claims that rental car transactions have dropped in the last two years as the average Uber or Lyft fare cost is generally much lower than the average car rental booking.

SEC filings from the two largest car rental companies showed weaker than expected results for Q1. On May 9, Hertz reported a net loss of USD 51mn for Q1 2016, citing a softer pricing environment, an increase in the proportion of small / midsize cars rented and lower fuel-related ancillary revenue. Avis announced a loss of USD 51mn during the quarter as a result of unusually soft pricing in the America. There is a widespread belief that Uber and Lyft have taken away the profits of short term car road travels from the major car rental firms. However, both firms did not mention Uber or Lyft in their filings or earnings calls as sales have not been materially affected.

The global car rental industry generated nearly USD 55bn in revenue during 2015. Sales in North America was USD 23bn, an amount which is largely dominated by an oligopoly of three firms – Enterprise Holdings (Enterprise), Hertz and Avis. Enterprise, a private company, is the largest of the three. According to ARN, Enterprise's revenue was nearly equal to the combined sales of Hertz and Avis in 2015.

Like Enterprise, the US is a key geographic business segment for Avis and Hertz. Last year, the companies posted sales of USD 8.07bn and USD 5.64bn from the country, accounting for 76.6% (Hertz) and 66.3% (Avis) of overall revenue, respectively. Together with sales in the US, international car rental transactions have been increasing. The Avis Budget Group grew its international sales business over the past few years, from USD 922mn in 2010 to USD 2.87bn in 2015.

The RMI-CRI 1-Year Probabilities of Default (PD) for Avis and Hertz have been on an uptrend since last year (see Figure 1). The 1-year PDs for Hertz and Avis were as low as 15.9bps and 10.5bps in January 2015, but increased to 332bps and 151bps, respectively, in February 2016. As of last Friday, the 1-year PDs for Hertz and Avis remained at an elevated level of 235bps and 134bps, respectively. The increase in the default probabilities were accompanied by marked declines in the firms' market cap. The market value of Hertz's shares has decreased by 41%, surpassing the 28% decline in the market value of Avis's shares between Jan 1, 2016 and May 20, 2016 (see Figure 2).

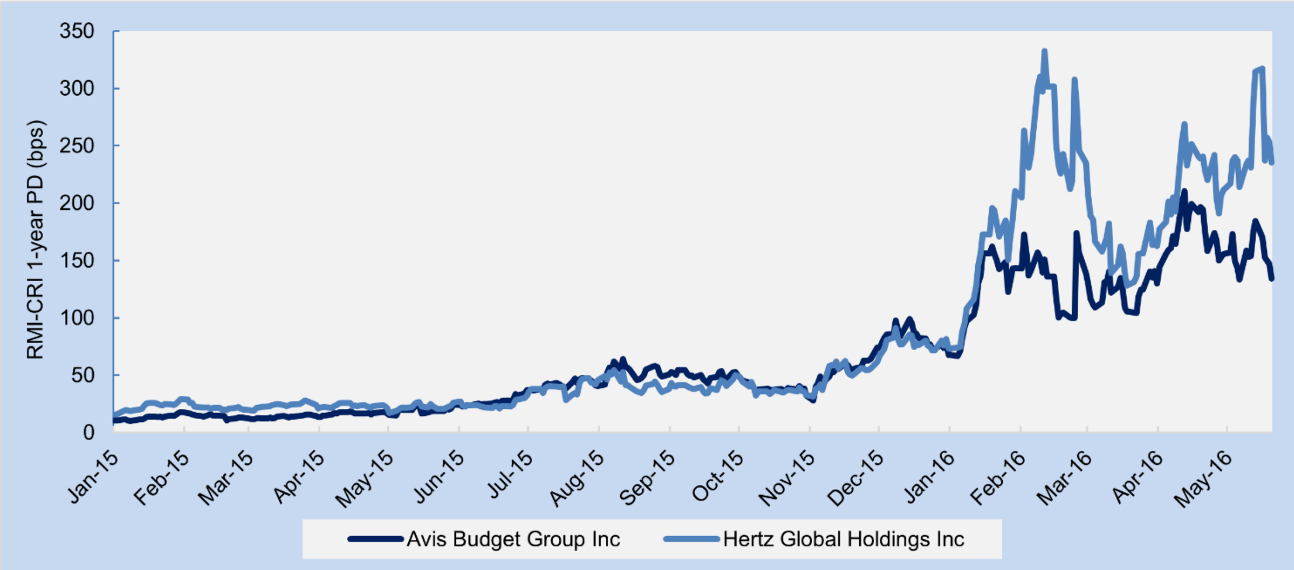

Figure 1: RMI-CRI 1-year PDs for car rental companies Avis and Hertz. *Source: RMI-CRI*

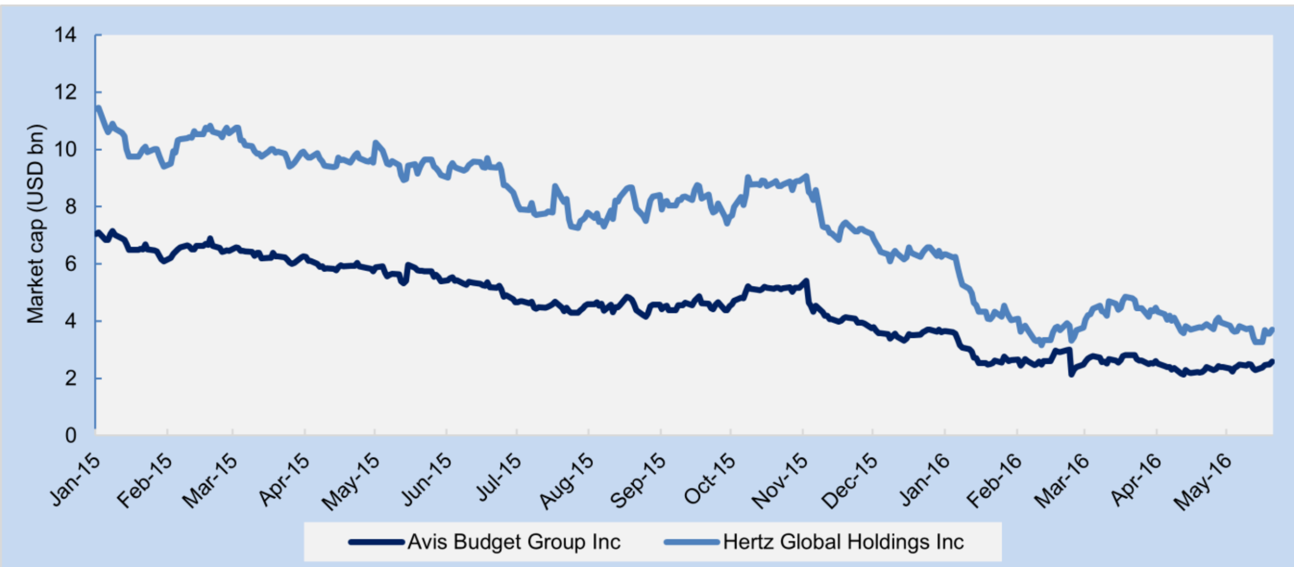

Figure 2: Market cap of Avis and Hertz. *Source: Bloomberg*

Despite having a larger market cap, the RMI-CRI 1-year PD for Hertz has exceeded the RMI-CRI 1-year PD for the Avis Budget Group. This is mainly due to a drop in the RMI-CRI Distance-to-Default (DTD) for Hertz. DTD is a volatility-adjusted measure of leverage, and changes in the measure are a significant determinant of the RMI-CRI 1-year PDs. DTDs take into account the daily changes in market cap as well as the firm's total liability, which includes the company's long term debt.

As of Q1 2016, the proportion of debt to total asset on the balance sheet of Hertz and Avis was 70.95% and 66.9%, respectively. Avis ended the quarter with USD 13.7bn of total debt and USD 876mn of cash and cash equivalents. 73.7%, or USD 9.86bn of the company's debt were asset-backed or asset-based financing related securities. Hertz had USD 10.1bn of asset backed debt during the March quarter, with USD 857mn in cash and cash equivalents and USD 353mn of restricted cash. Restricted cash are amounts set aside for the purchase of vehicles under the asset backed debt facilities and often fluctuate based on the timing of car purchases.

Due to the capital intensive nature of the business, both firms rely heavily on the asset backed debt market to fund their fleet purchases. The firms' credit profile could deteriorate from a sharp rise in financing costs if a firm is unable to refinance existing asset-backed debt or continue to finance new vehicle acquisitions on acceptable terms and on a regular basis.

In addition, the asset backed financing capacities of the car rental companies are linked to the financial abilities of major car manufacturers to repurchase or guarantee the depreciation rate of certain vehicles in their fleet. Large vehicle recalls due to faulty auto part components such as airbags may disrupt the rental company's fleet management, which may ultimately affect earnings. Borrowing capacities are also determined by the financing structure of the asset backed security and terms of contract, including the need for credit enhancement or extra cash collateral.

The quality of the securitized collateral is important and therefore any decrease in the value of cars could affect the firms' fleet cost and its ability to secure further funding. This is because of increased credit enhancement requirements as the market values of the vehicles have dropped below their book values. Additionally, certain situations may require the principle under the asset-backed debt to be repaid sooner than anticipated, forcing certain debt holders to exercise their right to sell vehicles to create sufficient proceeds to repay their obligations. These outcomes could hurt the firm's liquidity profile, disrupt rental operations and trigger cross defaults between various asset backed securities.

Looking ahead, the next few quarters may bring about some reprieve for the companies as the summer months are seasonally the strongest for car rental companies. The managements' outlooks for Q2 and Q3 have been quite optimistic as advance bookings for car rentals appear to be increasing by the month. However, industry analysts say that revenues traditionally have stronger correlations with the US airline traffic and GDP growth. Increasing car rental prices may also be difficult as the industry is highly competitive and car rental competitors, such as Enterprise with larger resources, may seek to gain more market share by competing on price.

Credit News

Valeant gets notice of default from bondholders

May 20. Canadian drugmaker Valeant said it received a notice of default from bondholders due to a delay in filing its Q1 report. Valeant added that it can avoid default through filing the report by July 18. Valeant was one of the pharmaceutical industry's widely owned stocks due to its aggressive acquisitions strategy which drove strong gains in its shares. Unfortunately, concerns over its prospects were being raised last summer due to questions over its accounting and business practices, as well as lawmakers' concerns about sharp price hikes. Valeant had filed its 2015 financial report last month, after missing the original March 15 deadline, citing an in-house review of its accounting practices. (CNA)

Bank of China plans 1st bad loan securitization

May 19. Bank of China is planning to sell bonds backed by non-performing assets and removing bad loans from its balance sheet. China banks face pressure to reduce their bad loans since 2005 due to sliding corporate profits and rising defaults that worsen credit strains. Presently, Chinese banks have been offloading bad debts to asset management companies. Due to China's sluggish economy, the bad loan ratio among Chinese commercial banks has hit 1.75% at the end of March, the highest level since 2009. Fitch suggested for Chinese banks to raise capital for bad loan securitization. The rating agency added that that bundling non-performing loans into bonds may crystallize losses and potentially require banks to raise more capital to offset write-downs. (Bloomberg)

Samsung Heavy Industries submits self-rescue plan

May 19. Samsung Heavy Industries' self-rescue scheme - which promised to raise KRW 300bn by disposing its non-core assets, dismissing 500 employees and suspending operations at some of its dockyards – was deemed unsatisfactory by its main creditor, the state-owned Korean Development Bank (KDB). Instead, KDB wanted Samsung Group to get involved to save its faltering shipbuilding business. Samsung Heavy Industries had not secured any new orders since November 2015 and the company's backlog orders stood at only 21 ships in April 2016. Samsung's shipbuilding business was negatively affected by sluggish cross-border trade, falling oil prices and competition from Chinese shipbuilders. The shipbuilder registered an operating loss of KRW 1.5tn in 2015 and a profit of KRW 6.1bn in Q1 2016 which fell short of expectations. (Korea Times)

Halcón reaches pact with creditors on prepackaged bankruptcy plan

May 18. Halcón Resources Corp, an oil production company, plans to file for a prepackaged bankruptcy that would wipe out USD 1.8bn in debt, helping the Houston-based company to tide over the plunging crude prices. This bankruptcy would stall Halcón Chief Executive Wilson's vision of building and selling Halcón to the highest bidder, similar to an earlier sale of Petrohawk to BHP Billiton by Chief Executive Wilson in 2011. While Chief Executive Wilson displayed confidence in the success in Halcón in a 2013 interview with Reuters, right from the onset, Halcón was riddled with high debt and costs despite possession of quality acreage. Halcón's debt restructuring plan would remove USD 222mn of preferred equity and reduce Halcón's annual interest payments by more than USD 200mn. (Reuters)

Dex Media files for Chapter 11 Bankruptcy Protection

May 16. Phone book publisher Dex Media Inc. filed for Chapter 11 Bankruptcy Protection after reaching a restructuring deal with creditors. The restructuring plan is subject to creditor vote and court approval and would likely leave senior lenders with the company's ownership. The company reported USD 1.27bn in assets and USD 2.65bn in debts as of December 31. Dex Media hopes to finalize the restructuring plan in the third quarter of this tear. The Chapter 11 filing marks the fifth time in seven years a yellow-pages company sought Chapter 11 Bankruptcy Protection. (WSJ)

SandRidge Energy files for bankruptcy protection (WSJ)

SunEdison Junior creditors to conduct bankruptcy probe (WSJ)

Caesars boosts offer to USD 4bn to settle bankruptcy fight (Bloomberg)

Regulatory Updates

Blockchain sends banking regulators back to basics

May 20. The rise of blockchain technology is forcing financial regulators to consider changes in the banking regulations. Using cryptographic algorithms, blockchain keeps track of and verifies transactions in the form of blocks that can be shared across the network but cannot be tampered or revised. The technology is potentially disruptive as it reduces the role of banks in making payment and facilitating transactions. Most regulators have been hands off given the relatively small investment in the fintech sector. However, more widespread adoption of the technology will prompt regulators to tighten the rule. Regulators still remain ambivalent about the blockchain as they are yet to determine the possible risks of the new technology. (Reuters)

US securities regulator takes aim at exchange-traded funds

May 20. The Securities and Exchange Commission (SEC), is placing greater scrutiny of exchange traded-funds following statements made by the agency's chair, Mary Jo White. This statement comes after action undertaken by the SEC to examine the funds for compliance with securities laws in January, and calls for heightened scrutiny by Commissioner Kara Stein in February. Over the last decade, the funds have increased by more than four-folds – currently having a total of USD 2tn in net assets, according to the Investment Company Institute. After a rule proposed by the SEC in December to clamp down on the way investment funds use derivatives, the industry has felt pressure, with some exchange traded funds considering to close or change their investment strategies if approved. However, the agency's chair, White, stated that the rule was intended to "provide an updated and more comprehensive approach to regulating funds' use of derivatives in light of the significant growth in the volume and complexity of derivatives over the past two decades and the increased use of derivatives by certain funds." (Reuters)

European banks fret over 'living wills'

May 18. Under the supervision of the US authorities, the twelve largest global banks must submit their living wills annually, outlining how they could be wound up without triggering a crisis or bailout. The four European banks (UBS, Deutsche Bank, Credit Suisse and Barclays) lobbied the US regulators to extend its July 1 deadline as they need to take into consideration the 2015 feedback - which they have not received – before submitting their 2016 plans. Five US banks' (JPMorgan Chase, Bank of America, Wells Fargo, Bank of New York Mellon and State Street) 2015 plans were rebuked as being not credible or would not facilitate an orderly resolution. They were required to remediate them by October 1 or they would face sanctions. Goldman Sachs and Morgan Stanley faced similar criticism while Citi's plan had "shortcomings that the bank must address" despite the fact that its plan was not rejected. (FT)

SECP amends Non-Banking Finance Companies and Notified Entities Regulations 2008, REIT Regulations 2015 (Radio Pakistan)

Europe's quest for bank 'bail-ins' pose risk to retail investors (FT)

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Contributing Editor: Khaw Ker Wei