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Weekly Credit Brief May 31 - Jun 06

Thomas Cook's outlook is unclear but debt is real

by Justin Hsiao

On May 19, UK-based Thomas Cook Group PLC (Thomas Cook), the second-biggest travel agency in Europe, released a statement that its bookings for this year's hot season were 5% lower than last year mainly due to terrorist attacks in Tunisia and Brussels. The announcement coincided with the news of the disappearance of an EgyptAir flight from Paris to Cairo. Later that day, its share price fell 19% in a single trading day amid the concern that consumers would be reluctant to travel for safety reasons.

Thomas Cook's share prices have plunged 40% so far this year. According to RMI-CRI's credit measure, the firm's credit health has deteriorated to a three-year low, as its business faces unfavorable regional events, its business model suffers internet disruption, and its indebtedness remains high. As shown in Figure 1, the RMI-CRI 1-year Probability of Default (PD) for Thomas Cook has surged from 36bps at the beginning of 2015 to 89bps, a three-year high, on Jun 3, 2016.

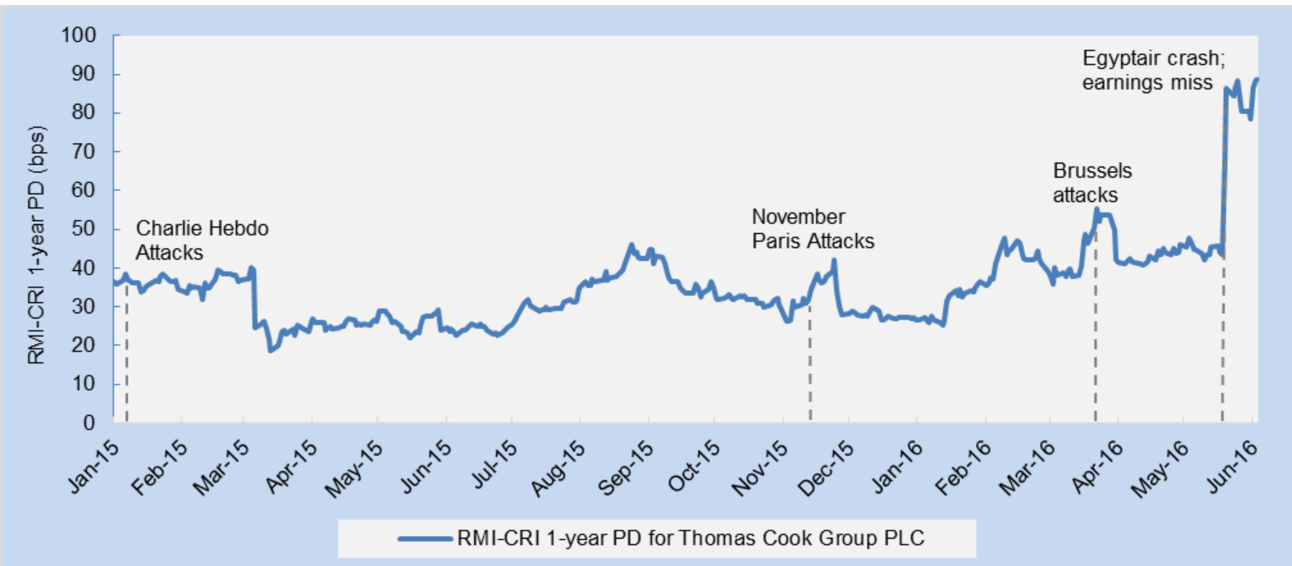

Figure 1: RMI-CRI 1-year PD for Thomas Cook Group PLC and major travel deterrents in Europe. *Source: RMI-CRI*

The travel business is sensitive to geopolitical and macroeconomic events. In 2015 and so far this year, a series of major terrorist attacks in Europe, such as the Brussels and Paris terror attacks, caught global attention. These events are weighing on the Europe-wide travel market, accounting for over 60% of the total revenues of Thomas Cook. On the other hand, Brexit fears have brought down the value of the British pound, which is expected to lower the incentive of the British to book their holidays to foreign countries, hurting the travel agent's profit from home. In the left panel of Figure 2, the amount of total revenue of Thomas Cook decreased from H2 2013 to H1 2016 regardless of the seasonal effect. In the same time period, the percentage of revenue from continental Europe decreased as well, indicating the withering travel business in the region.

Furthermore, Thomas Cook's 175-year-old business is under pressure from growth in new business models such as online booking systems and budget airlines. In 2012, Expedia, an online travel agency founded in 1996, became the world's biggest travel agent in terms of sales. Several online travel agencies, such as Priceline and TripAdvisor, also seized this opportunity to grow. According to Statista, online travel sales worldwide in 2015 were USD 533.52bn, and are expected to increase to USD 762.34bn in 2019, as shown in the right panel in Figure 2. Even some leading industry players want to catch up with this online trend. TUI AG, the world's largest tourism company and Thomas Cook's main competitor, provides internet based services for travel information and booking, which accounted for 6.13% of the firm's total revenue in 2015.

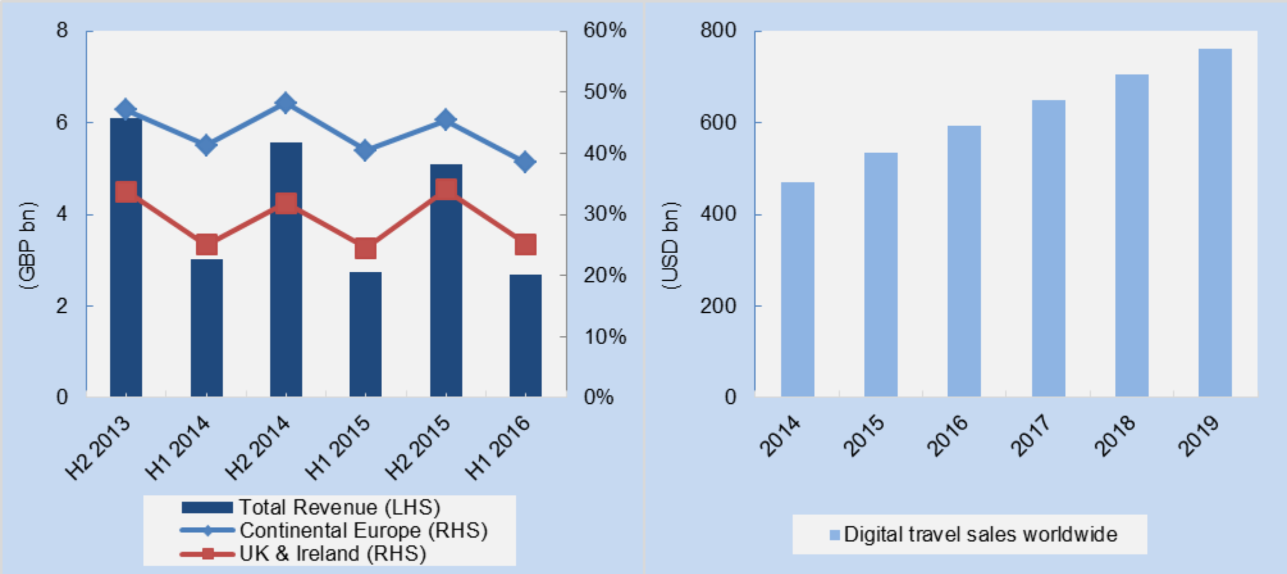

Figure 2: Revenue breakdown of Thomas Cook Group PLC (left panel) and digital travel sales worldwide (right panel).
Source: Bloomberg, Statista

Despite the intense competition, Thomas Cook has little financial flexibility to invest in the business. The travel firm is struggling to generate the cash needed to fulfil its modernizing ambitions. As shown in Table 1, the firm's cash ratio was only 0.17x in H1 2016, lower than 0.22x in H1 2015. The retained earnings were all negative in this period. The total liabilities to total assets ratio was 99% in H1 2016. The high indebtedness constrains the firm's abilities to withstand the industry hardships and to adjust itself according to the ever-changing business environment, making the firm more vulnerable to any further market shocks.

	H1 2015	H2 2015	H1 2016
Cash Ratio	0.22	0.35	0.17
Retained Earnings (GBP bn)	-2.30	-1.78	-2.08
Total Liabilities / Total Assets (%)	102	94	99

Table 1. Credit metrics of Thomas Cook Group PLC. *Source: Bloomberg*

Credit News

China's regional funding fix leaves questions for S&P, Moody's

Jun 6. According to S&P and Moody's, China's efforts to bring transparency to regional finances have not eradicated risky fundraising methods. Fueled by a program to swap expensive debt for cheaper municipal securities, direct sales of local government bonds have surged to a record CNY 2tn. While the newly implemented municipal notes are a more transparent way of raising money, authorities are still resorting to the off-balance-sheet funding method. The off-balance-sheet financing increases uncertainties in the financial system that could exacerbate any potential financial shock. Despite the negative outlook from the two rating agencies, Chinese government asserted that overall risk associated with government debt are still under control. (Bloomberg)

S&P scorned by investors for keeping Asia's best debt at junk

Jun 6. Investors maintain their faith in Indonesia's sovereign bond market, despite being downgraded to junk status by S&P. Notably, Indonesia's ratio of debt to GDP is the lowest in Asia after China. Rupiah-denominated sovereign debt has attracted USD 4.7bn of inflows in 2016 as pickup in government spending strengthened sentiment towards Southeast Asia's largest economy. Economic growth from a 6-year low has been boosted by three interest-rate cuts this year. S&P defended its decision by claiming its usual application of sovereign rating criteria and peer comparison analysis. S&P presently has not ruled out the possibility of an upgrade. (Bloomberg)

AusGroup calls in KPMG after breaching debt covenant

Jun 3. KPMG was called by Australian resources contractor AusGroup for assisting it out of its financial storm, after breaching a debt covenant with noteholders and incurring significant losses. In attempting to get a waiver from holders of the unsecured notes in relation to the breach and event of default, AusGroup appointed KPMG to carry out independent business reviews and implement strategic plans for the company. AusGroup Singapore reported a net loss of SGD 93.5mn for the nine months to March 31, 2016. (The Australian)

Big rating agencies steer clear of Peru's defaulted debt

Jun 2. The world's largest credit rating agencies are resisting efforts by a US hedge fund to embroil them in a dispute over Peru's defaulted debt. Moody's, Fitch, and S&P rejected Gramercy's offer to pay for ratings on long-defaulted Peruvian bond. The hedge fund, in turn, accused the rating agencies of protecting their commercial relationship with the Peruvian government. Fitch rejected the offer as there was insufficient information; the bonds are decades old and issued in a currency that no longer exists. Moody's cited the lack of official documentation and information on the bond's terms and conditions for its unwillingness to analyze Peru's long-defaulted bond. (FT)

Risky reprise of debt binge stars US companies not consumers

May 31. Instead of the previously consumer-driven recession, companies could be the driver for the next recession. Though this is still too early to say, the risk, nevertheless, exists. Due to record-low interest rates, corporate borrowings have increased by USD 2.8tn since 2009 to USD 6.4tn which, historically, led to problems as companies cut down spending and hiring. Borrowings were spent inefficiently (e.g. to finance share buybacks, boost dividends and acquisitions) instead of increasing corporate efficiency and operation capacity. The bottom 99% corporations, with record low cash-to-debt ratios, were most at risk should credit conditions tighten. More than 50 US companies had already defaulted on their debt so far in 2016. Meanwhile, profits also shrunk where S&P 500 earnings fell 7.1% YoY in Q1 2016 due to lagging worker productivity and mounting labor costs, which in turn pressured firms to cut down repurchase, acquisition, capital spending and inventories. (Bloomberg)

SoftBank gets serious about tackling debt with asset sales (Bloomberg)

Negative-yield debt breaks USD 10tn level for first time (FT)

AnaCap raises EUR 595mn to buy European banks' credit assets (SCMP)

Regulatory Updates

China's central bank tightens reserve requirements for offshore yuan banks

Jun 3. People's Bank of China (PBOC) tightened the reserve requirements for off- and onshore yuan banks to smooth out money market fluctuations. Instead of the previous quarter-end and period-end requirement, banks would have to reserve a fixed sum based on a percentage of their average level of deposits over a previous quarter as well as reserve a 10-day period average level of deposits as the calculation for the reserve requirement for offshore and onshore yuan, respectively. ANZ said the new rules could motivate the offshore banks to cut their average yuan holdings to avoid paying up for the new requirements. Analysts also mentioned the banks would try to reduce the average offshore yuan deposits to reduce reserve requirement which will be submitted in July. (SCMP)

Fed outlines new capital requirements for insurance firms

Jun 3. The Federal Reserve had outlined measures towards imposing tougher capital requirements on insurers tagged for heightened oversight, guiding companies after years of uncertainty about the process. However, key details that include the specific numerical capital requirements for large insurers Prudential Financial Inc. and American International Group Inc. (AIG), both insurers which had been tagged “systemically important” by US regulators, will be slated later. The outlined measures for insurance firms under the Fed’s purview, suggests a tougher set of rules for Prudential Financial Inc. and AIG than for 12 insurance companies that own banks and will be up for public comment before a draft rule is published. The Fed had also prepared a separate proposal detailing risk-management and liquidity rules for Prudential Financial Inc. and AIG. Chairwoman of the Federal Reserve Janet Yallen, stated that the proposal is a crucial step towards capital standards, supervising insurance firms and enhancing the resiliency and stability of the US financial system. (WSJ)

ECB rules out automatic sales of corporate bonds cut to junk

Jun 2. The European Central Bank (ECB), unveiling details of the latest expansion of a stimulus program, mentioned that it will not be selling notes that are downgraded to junk even if the ratings of these securities fall below the criteria for purchase in the rebooted quantitative-easing plan. This decision, which comes before the ECB begins buying corporate debt, may be reflective of the ECB’s desire to avoid creating price swings in the market. The details of the stimulus program includes the eligibility of the ECB’s purchase of notes issued by non-bank companies with an investment grade from at least one ratings provider and also the purchase of securities with negative yields conditioned on the securities having yields above the deposit facility rate of -0.4%. The announcement in March that the ECB would start purchasing corporate debt aided in driving borrowing costs to record lows and spurred a flood of issuance. (Bloomberg)

Infra projects: RBI eases refinancing norms for NBFCs (Moneycontrol)

SEBI to tighten norms for credit rating agencies (Indian Express)

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