



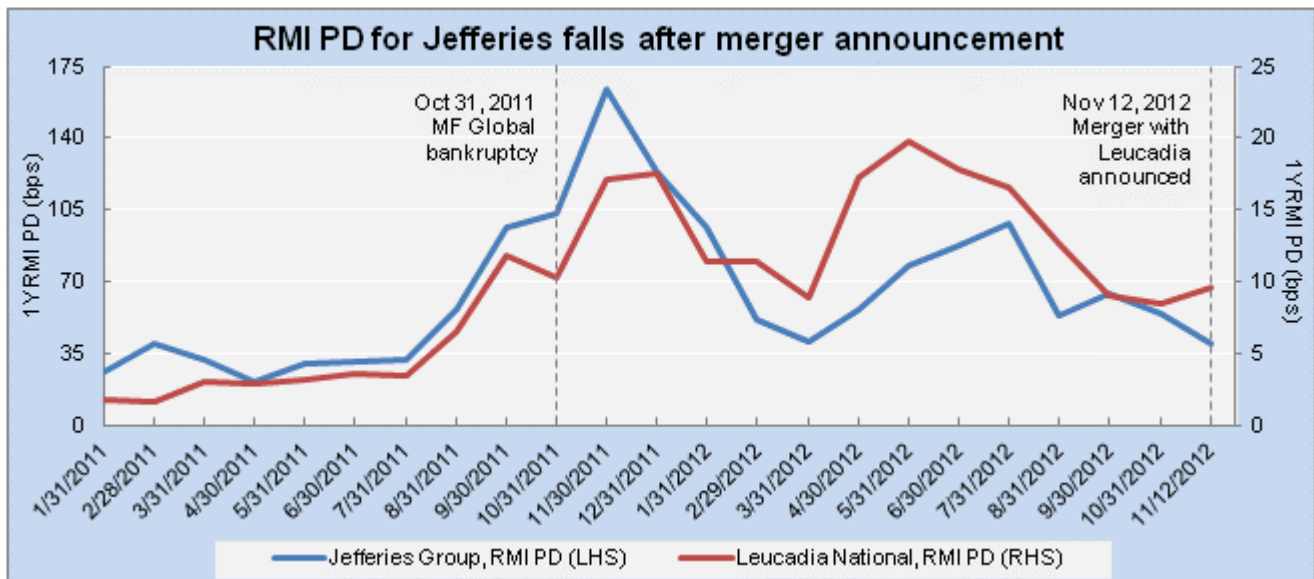
Stories of the Week

Jefferies agrees to sell itself to Leucadia in credit positive move

By [James Weston](#)

The 1-year RMI probability of default (RMI PD) for US-based investment bank Jefferies fell on November 12, after the company agreed to sell itself to its largest shareholder Leucadia National, which already owns 28.6% of Jefferies. A diversified investment firm in the mould of Berkshire Hathaway, Leucadia National owns businesses including beef processors, mining companies and auto retailers.

The move is a credit positive, as overall liquidity will increase and the combined company will have significantly lower leverage, relative to Jefferies standalone leverage. This also creates some downside risk however, as a more leveraged Leucadia would be more exposed to potential losses at its subsidiary investments, somewhat explaining the slight increase in the RMI PD for Leucadia on November 12.



The combination should better protect Jefferies from market dislocations. The RMI PD for Jefferies reached a 2-year high in November 2011, as market participants became concerned about the bank's holdings of European sovereign debt, and the potential for Jefferies to suffer the same fate that befell MF Global. Jefferies averted further pressure by reducing the size of its European trading positions and increasing disclosure. The combination will allow Jefferies to grow and invest with less exposure to market pressures, facilitating Jefferies' aim to become a bulge bracket investment bank.

Jefferies, which will be the largest business of Leucadia, will continue to operate as a full-service global investment banking firm in its current form. Jefferies management will run the combined company, facilitating management succession at Leucadia. Senior Leucadia management will move to boardroom roles, preserving overall franchise value.

The move is a credit positive for bondholders, as it will substantially increase the amount of equity available to guard against potential losses. According to the firm's latest financial statements, Jefferies had USD 3.71bn of equity supporting USD 34.4bn of assets, while Leucadia had USD 6.19bn of equity supporting USD 8.74bn of assets. These numbers translate into respective accounting leverage ratios of 9.27x for Jefferies and 1.41x for Leucadia. The combined company is projected to have USD 9.3bn of equity supporting USD 42.1bn in assets, or leverage of 4.53x.

Leucadia had about USD 2bn in cash and liquidity as of Sept. 30, while Jefferies had USD 2.8bn billion in cash. The merger will give Jefferies access to a steadier stream of cash from Leucadia's other subsidiaries. Moreover, Jefferies extremely resilient pre-tax earnings will allow Leucadia to utilize net operating losses for tax purposes.

Sources:

[Leucadia - Jefferies: A unique combination](#) (Jefferies)

[Jefferies to sell itself to Leucadia in USD 2.8bn deal](#) (Bloomberg)

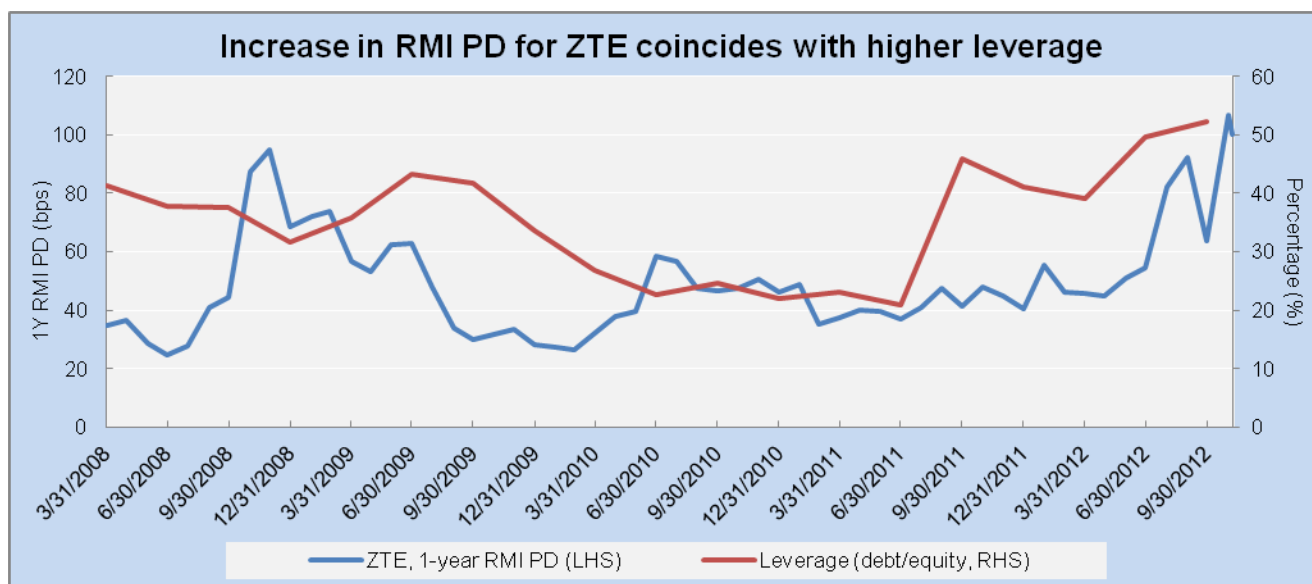
[Jefferies CEO's duties grow in Leucadia deal](#) (WSJ)

RMI PD shows credit outlook for ZTE has declined

By [Dexter Tan](#) & lao Chi Wa

The 1-year RMI probability of default (RMI PD) for ZTE has risen sharply after the firm announced negative Q3 earnings last month. As shown in the figure below, the RMI PD for ZTE has risen above highs last seen during the 2008 global financial crisis (GFC). ZTE provides telecommunications equipment and network solutions to clients in 140 countries, and also manufactures smartphones.

The company recently reported its first quarterly loss since 2004 amidst a cutback in capital expenditure by network carriers worldwide. The firm recorded a CNY 1.95bn loss during Q3 on lower profits from Europe and Asia. Moving forward, the firm faces numerous challenges including a bad reputation in the US, high leverage, margin pressures and stiff competition in the smartphone industry.

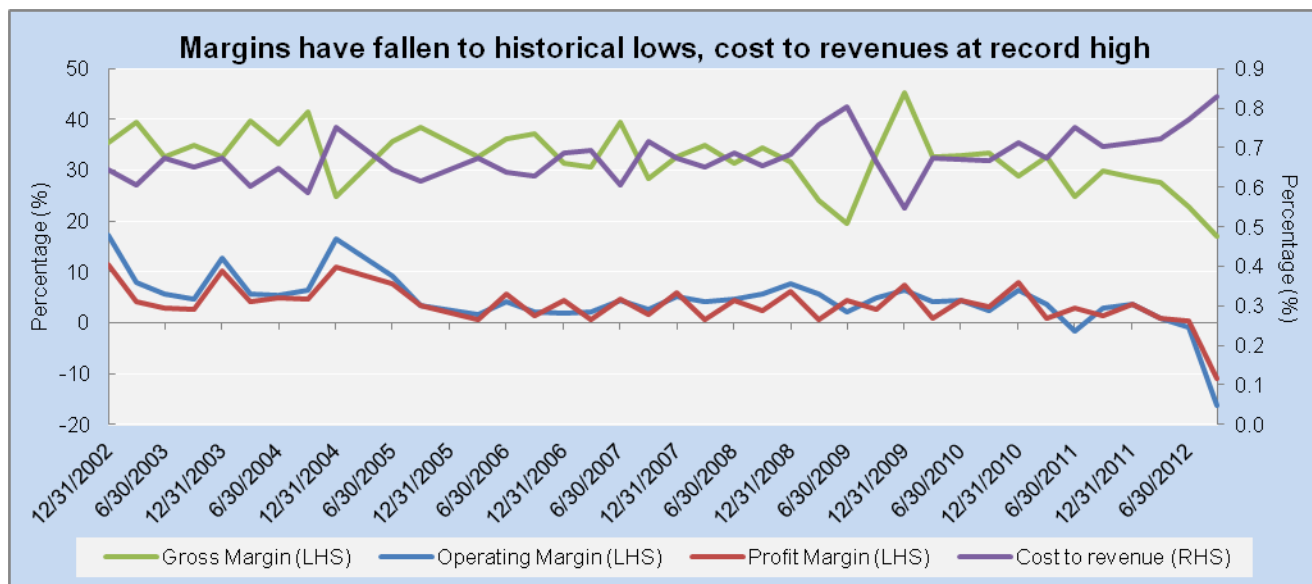


China accounts for most of the group's revenue (49%), while Europe, the Americas and Oceania account for 23% of sales, according to financial statements for the quarter ending 30 June. Asia (excluding China) on the other hand accounts for 18.8% of revenues. The firm has three operating segments. Half of its revenue is made delivering data communication products and services to network carriers. Manufacturing and selling telecommunications equipment account for 33.4% of total revenue, while 16.6% comes from providing software systems.

Reputational risks: In July 2012, the firm received a notice filed with the International Trade commission (ITC) and the Federal District Court of California contending that the company and its US subsidiary infringed the patent rights of several US companies. The ITC is investigating the claims which could lead to its telecommunications products being banned in the United States. Separately, the US House of Representatives Intelligence Committee is accusing the company of selling subsidized kits in the country. The company is also being faulted by the FBI for illegally selling US tech equipment to Iran despite economic sanctions being implemented against the country. Cisco, a former large client of the company, has stopped doing business with ZTE.

Asset sales and increasing leverage: The sale of 68% of ZTE Special Equipment is expected to raise CNY 360mn to CNY 440mn. A 3-year bond issuance in June 2012 increased the amount of bonds outstanding at the end of Q3 to CNY 6.01bn from CNY 3.88bn nine months earlier. ZTE is expected to use the proceeds of recent issuance and asset sales to repay bank loans and provide working capital for the firm. The firm's current and quick ratios were close to record lows at the end of Q3, while the firm's leverage, measured by its debt to equity ratio, has increased to the highest on record.

High operating expenses: ZTE's margins are under pressure with the cost to sales ratios in Q3 the highest on record. The company's cash conversion cycle was 113 days according to its latest financial statements with the inventory to total assets ratio at 27.4%. Bad debt provisions have increased but they are unlikely to affect the company's finances significantly at this point. There is an urgent need to restructure costs at the company. Management plans to slash operating costs, R&D expenditure, consolidate products that have little potential and cut jobs. Operating and net income margins were in negative territory at the end of Q3, and are unlikely to recover in the short term.



Mobile division faces stiff competition: According to intelligence firm IDC, ZTE's handset revenue represented 2% of the global market at the end of Q2. This pales in comparison to market share of 31% for Samsung's and 23% for Apple. ZTE's revenues from mobile phones increased to USD 1.58bn in Q2 from USD 1.29bn in Q2 2011, but have yet to pick up substantially. The company is attempting to expand smartphone sales and plans to launch a Windows Phone 8 device to rival Samsung's Android-based Galaxy Note 2. The 16.6% gross margin in ZTE's mobile phone division is the lowest among peers. The company has invested heavily in R&D for mobile phones with no exceptional breakthroughs. R&D costs increased to CNY 6.68bn in the first nine months of 2012, higher than the CNY 5.62bn spent in the same period a year ago.

Questionable strategies: ZTE is too reliant on network operators in China as they account for 90% of ZTE's mobile sales. Only 10% is sold through the open-market. This gives large clients like China Mobile and China Unicom a lot of bargaining power in negotiations with ZTE, which could undermine the firm's revenues. ZTE's low-pricing strategy is also unsustainable in the longer term. By selling a higher number of low end models through the open market, ZTE could easily find additional sources of revenue.

According to Taobao.com, the biggest online shopping mall in China, the average price for a ZTE smartphone is USD 180, much lower than prices for Apple and Samsung smartphones. ZTE has found it difficult to build up brand loyalty effectively with consumers. Taobao.com showed that ZTE's main buyers are from the young and low to middle tier income segments, suggesting that their low priced phones only attract customers with corresponding purchasing power.

Sources:

[Huawei & ZTE face further investigation into Chinese 'spying' allegations](#) (The Telegraph)

[Cisco breaks with ZTE over Iran sales](#) (Reuters)

[Apple and Samsung account for 106% of smartphone profits in 2012 Q3](#) (Sina)

In the News**Credit swaps in US rise most in six weeks**

Nov 9. The Markit CDX North America Investment Grade Index (Series 18) rose to the highest point in two months, reaching 95.95bps on November 9. Investors use the index to hedge against losses or to speculate on corporate creditworthiness. Uncertainty about the ability of legislators to reach a budget compromise following US elections has raised investor concern about the potential impact on corporate balance sheets. US Democrats retained the presidency and control of the Senate, while Republicans kept a majority in the House of Representatives. Over USD 600bn of tax increases and spending cuts will take effect in January if lawmakers fail to reach a compromise. ([Bloomberg](#))

Rising bad loans keep pressure on Italian banks, government rejects bad bank

Nov 8. Italian banks are cutting lending to businesses to offset rising bad loan levels and reduce funding needs. Data released last week showed loans to non-financial companies fell 3.2% year-on-year during September. Deutsche bank expects provisions for bad loans at Italian banks will be higher in Q3 and could worsen in Q4. In related news, the Italian Treasury rejected proposals from restructuring advisors to create a bad bank that would take non-performing loans (NPL) off the books of Italian lenders. Treasury officials believe the mechanism could strengthen the link between sovereign and bank debt, and said there is currently no official plan to create a bad bank as deteriorating credit is in line with the government's expectations. ([Reuters](#), [Bloomberg](#))

Market eyes Barclays CoCo for clues on price, regulation

Nov 6. Both investors and regulators are focusing on a potential USD 2bn contingent capital (CoCo) bond issuance by Barclays. The notes will automatically be written down to zero if the lender's Tier 1 Common Capital ratio falls below 7%, the most aggressive structure yet. Barclays had a Core Tier 1 capital ratio of 11.2% at the end of September; the bank expects this number to fall to 10.4% next year under full Basel III rules. Previous CoCo issuances by other banks either have a lower trigger or convert to equity if triggered. The UK Financial Services Authority has been actively involved in the issuance, and believes the issuance is adequately protected by the minimum 9% Core Tier 1 Capital ratio Barclays must maintain in order to continue discretionary payments to shareholders and employees. ([Reuters](#))

Published weekly by [Risk Management Institute](#), NUS | [Disclaimer](#)

Contributing Editor: [James Weston](#)