GE fighting to keep its investment-grade status

By Luo Weixiao

General Electric Co (GE), the 126-year-old industrial conglomerate, was once one of the most valuable and largest companies in the US. However, GE has seen its market capitalization plunged by approximately 60% this year, 86% lower than its highest level in 2000 and only 22% higher than its lowest level in 2008 Financial Crisis. The RMI-CRI 1-year Probability of Default (PD) for GE surged to 134bps in Nov 2018 from 4bps in Nov 2017. The RMI-CRI Probability of Default Implied Rating (PDiR), which is a grading system which maps the RMI-CRI 1-year PDs and observed default rates of Standard & Poor's (S&P) credit cohorts, also reflects a change in credit quality. PDiR sent a downgrading signal (to BBB+) this February when GE's market value just started to show the decreasing trend.

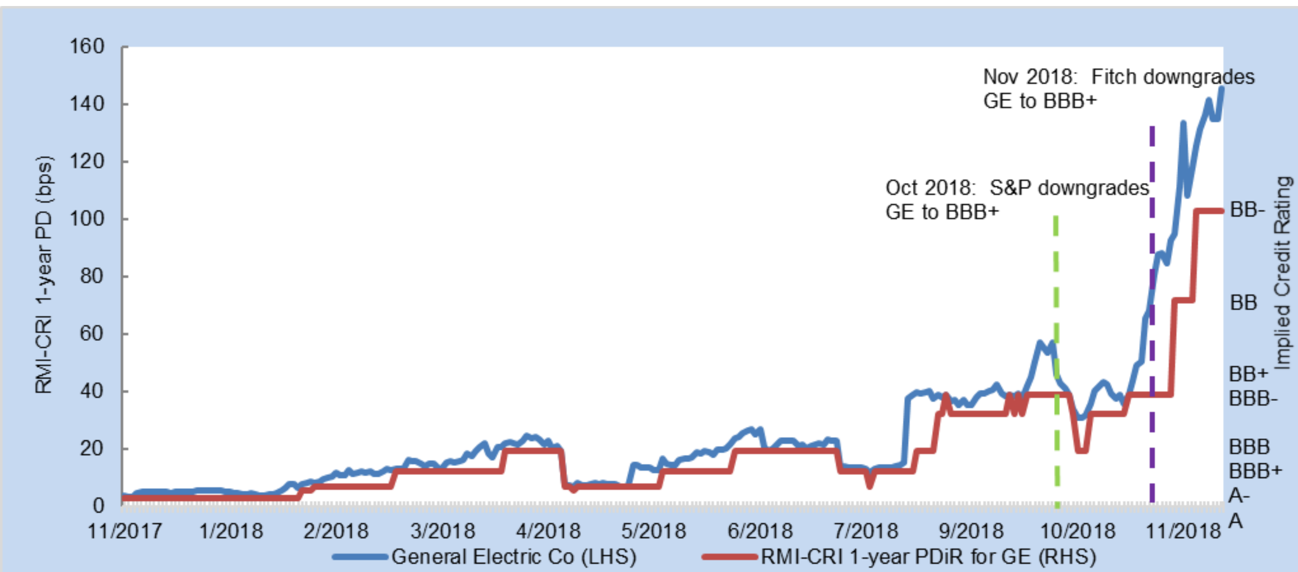

Figure 1: RMI-CRI 1-year PD and implied credit rating for General Electric Co. *Source: RMI-CRI*

Eight months later, S&P cut GE's credit rating from A to BBB+, concerning the weakness in the power segment. Within one month, Moody's and Finch also downgraded GE by two notches. Moody's highlighted the adverse impact on GE's cash flows from the deteriorating performance of the power business and expected it could last some time.

The power segment is the key business of GE, constituting the largest part of its revenue as high as 25%-30%, but it has been problematic for years. At the core of the problems is its failure to forecast a downturn in demand for its turbines, the titanic machinery that powers natural gas and coal-fired power plants. That failure left GE with too much capacity in a market that is cooling off amid booming demand for renewable energy. The acknowledgement that faulty blades have been found on some of its newest turbines this year made the situation worse, raising worries about the potential cost of fixes.

GE acquired French multinational Alstom Energy, which makes turbines using fossil fuels, in 2015 when renewable energy was taking off around the world. The deal cost GE USD 10.6bn and was GE's largest-ever industrial acquisition. In its news released, GE saw great value in the acquisition and projected high growth and margin. GE considered it as a "highly strategic transaction", which had potential to generate high growth and margin and was core to the future of GE. Not surprisingly, it hasn't worked out as planned. The underperformance of Alstom in the following three years forced GE to rearrange its power business and rely more heavily on other segments including aviation, healthcare and transportation. In Q3 2018, the impairment test of goodwill showed that almost all the remaining USD 23.2bn of accrued goodwill on the power division's balance sheet is actually worthless, most of which relates to the 2015 Alstom deal. After reporting a USD 23bn write down of goodwill, the net income dropped to negative USD 22.7bn in the third quarter of 2018.

GE's trailing twelve months revenues in the power sector in Q3 2018 fell for the sixth consecutive quarter, down 8.62% from the last quarter and 20.13% from the same period last year. Orders for new equipment were down 26 percent at USD 7.4bn. In light of that, GE cut about USD 560mn of costs in the first half of 2018, more than half its target of USD 1bn.

	2017Q1	2017Q2	2017Q3	2017Q4	2018Q1	2018Q2	2018Q3
T12M Revenue (USD bn)	118.73	117.48	119.11	119.03	120.81	121.82	120.73
T12M Net Income (USD bn)	8.52	6.67	6.00	-7.31	-8.37	-8.63	-32.76
T12M Power Sector Revenue (USD bn)	37.34	37.47	37.00	34.88	34.16	32.34	29.55
T12M CFO/Avg Current Liabilities (X)	-0.0029	0.014	0.014	0.031	0.036	0.032	0.022
T12M EBIT to Interest Expense (X)	5.11	4.61	2.37	1.72	1.70	1.33	1.88

Table 1: Financial ratios for GE. *Source: Bloomberg*

Meanwhile, the outlook of the power sector remains bleak. As disclosed in the last 10-Q filing, GE's outlook for its power segment continued to deteriorate driven by the significant overcapacity in the industry, lower market penetration as well as uncertain timing of deal closures due to financing and the complexities of business arrangements in emerging markets. Thus, the company's earning, cash flow and credit metrics could still remain under pressure.

Apart from the power segment, GE's lending arm - GE Capital has a funding gap as huge as USD 20bn through 2020, estimated by Goldman Sachs analysts. GE Capital has a USD 24bn debt due in 2019/2020, and the earnings it generates is not expected to cover the debt payment given its recent performance. It is expected that GE Capital will fund its shortfall through asset sales as well as seek an equity infusion from its Parent.

Looking forward, GE is facing expanded investigation from both SEC and DOJ regarding its accounting practices related to the USD 23bn write down. GE reserved USD 1.5bn in April for a potential legal settlement of the DOJ investigation. Cash generation is also expected to deteriorate further due to weak performance in its core business. Its refinancing costs will also rise and GE may face another round of sell off on its stock and bonds.

Credit News

Jewelers find exports tough as India bank fraud squeezes credit

Nov 26. India's jewelry exporters have been struggling to obtain credit due to India's biggest bank fraud which caused the central bank to step in to ban short-term financing in foreign currency to limit the damage to the financial system. India's gem and jewelry exports account for 16% of the country's total goods shipments to global markets and have already dropped by 2% in the seven months to October. The jewelry sector is a working-capital intensive industry and is dependent on short-term financing to purchase materials. Therefore the tight credit is making it difficult for the companies. On the whole, the sector is not expecting exports to grow this year. (Bloomberg)

Bank of Italy sounds the alarm over banks' stability

Nov 24. Affected by the threat of EU's sanctions over the draft budget, Italy's sovereign debt yields hit their highest levels since 2014 last month. A following financial stability report published by Italy's central bank warned that the high debt yields would cost the nation, which has the second-largest debt as a proportion of gross domestic product in the Eurozone after Greece, about an additional EUR 9bn a year in interest costs on its debt till 2020. The increased bond yields would make it more expensive for Italian companies to borrow. And the deterioration in liquidity and capital adequacy indicators could threaten the stability of banks and insurers. (FT)

China developers bite the bond bullet with funding costs spiking

Nov 23. China's home builders have sold about USD 37bn of dollar bonds so far this year for refinancing and the average yields on Chinese junk bonds, mainly consists of developers, have increased to a four year high of 11.8%. Chinese developers have been facing increasing borrowing costs. It could be worsened as there have been talks about stricter assessments for companies looking to extend the validity of their offshore debt issuance quotas overseen by the China's National Development and Reform Commission. Developers have been bounded by tight funding conditions due to a deleveraging push by policymakers and the rise in global interest rates. The developers have a combined USD 62bn of bonds maturing in both onshore and offshore markets in 2019. (Bloomberg)

Singapore's financial system resilient amid greater global risks: MAS

Nov 23. The Monetary Authority of Singapore (MAS) said that the tighter financial conditions and ongoing trade tensions have increased risks but highlighted that Singapore's system remains resilient. Stress tests conducted by MAS showed that companies, banks and households can withstand external shocks but need to guard against weaknesses. MAS highlighted that trade related sectors such as manufacturing turned more cautious due to uncertainty in the global economy. Loan growth remained healthy over the past year as it was helped by advanced economies' credit intermediation to emerging Asia. However, MAS urged banks to remain vigilant by maintaining sound underwriting standards and have ample provisioning buffers with the increased lending activities and the rise of interest rates. (The Straits Times)

Chinese defaulter's move leaves investors worried

Nov 22. By mid-2018, Coal miner Wintime Energy Co had found itself incapable of servicing CNY 15bn of local bonds. Now it is proposing to include a USD 500mn note sold by its healthier subsidiary Huachen Energy Co in a CNY 70bn overall restructuring package. The bundling of offshore notes belonging to a subsidiary together with the obligations of its sicklier parent may appeal to Wintime creditors, but they may be less appealing to investors who consider subsidiaries as independent issuers. This restructuring exercise also raises questions about creditor rights in the USD 804bn offshore Chinese corporate-note market. (Business Times)

Singapore bonds face contagion fears from Lippo probe (Bloomberg)

China allows foreign firms to join credit monitoring system (Business Times)

Refinancing risk in Asia to 'remain low and manageable' over next 5 years: study (Business Times)

Regulatory Updates

FSB publishes recommendations on compensation data reporting to address potential misconduct risk

Nov 23. The Financial Stability Board (FSB) has issued a list of recommendations for regulators to address potential misconduct risk among bank employees. According to the FSB, current governance and risk management processes surrounding compensation should 1) factor employee conduct considerations 2) combine performance measures and compensation rewards to promote good employee conduct 3) promote wider risk management goals and 4) help to identify emerging misconduct risks to ensure that firm incentives, risk tolerance limits and compensation rewards are aligned. (FSB)

Agencies propose community bank leverage ratio for qualifying community banking organizations

Nov 21. US banking regulators are proposing to introduce a small bank capital leverage ratio of 9 percent as it aims to simplify capital requirements for small banks, or lenders not exceeding USD 10bn in assets. The Community Bank Leverage Ratio (CBLR) measures the bank's tangible equity to average total consolidated assets and is a simplified methodology to measure capital adequacy for community bank. Under the proposal, community banks would no longer be required to calculate or report the components of capital used in the calculation of risk-based capital ratios or the tier 1 leverage ratio. Standards referencing risk-weighted assets would be amended to use average consolidated total assets instead. (Federal Reserve)

SEBI taps ratings firms for NBFC health report (Economic Times)

IMF urges China's central bank to improve communications to ensure financial stability (SCMP)

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