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Singapore machinery sector bears brunt of economic slowdown

by Dexter Tan

Singapore's economy probably grew at its slowest pace in 4 years during the third quarter as both the manufacturing and services sectors entered negative territory with annual contractions of 17.4% and 1.9%, respectively. Manufacturing output was weighed down by the transport engineering and biomedical manufacturing sub-sectors which contracted sharply during August and September. RMI-CRI data tracking the 1-year probabilities of default (PD) for listed Singapore domiciled companies showed that machinery firms have the highest aggregate 1-year PD of all sectors* (see Figure 1).

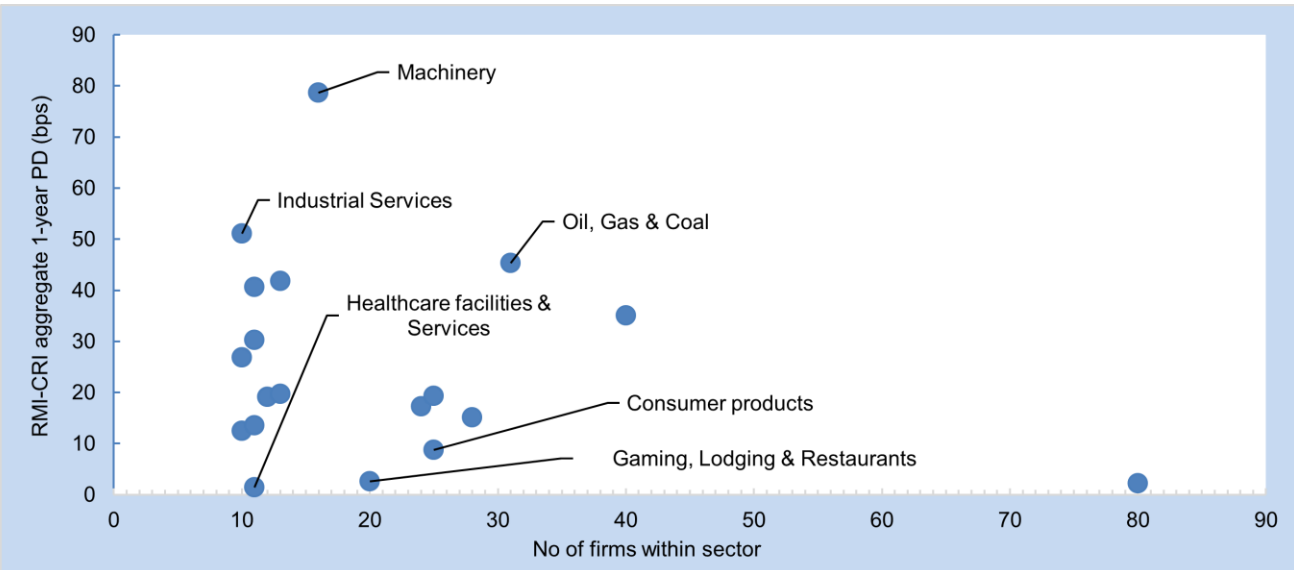

Figure 1: RMI-CRI 1-year aggregate (or median) PDs for Singapore industries on Oct 14, 2016. *Source: RMI-CRI*

Service oriented firms, or healthcare, hotel and food companies have stronger overall credit profiles than companies in the industrial, oil and gas sectors. Many manufacturing firms have weak credit metrics as the economies of Singapore's largest trading partners – China and Europe have slowed down, leading to lower demand for Singapore's exports. Oil and gas companies, in particular have seen a number of defaults this year as a result of low commodity prices.

Compared with the 1-year median PD for 551 Singapore firms, RMI-CRI default probabilities suggest that machinery companies are five times more likely to default than the median firm within the next 12 months. As shown in Figure 2, the RMI-CRI 1-year aggregate Probability of Default for 22 machinery corporations has been on an uptrend since June, after falling slightly between February and May. The aggregate 1-year PD soared to 76bps - the highest level since 2009 on Sep 20, 2016, before falling to 70bps on Oct 14.

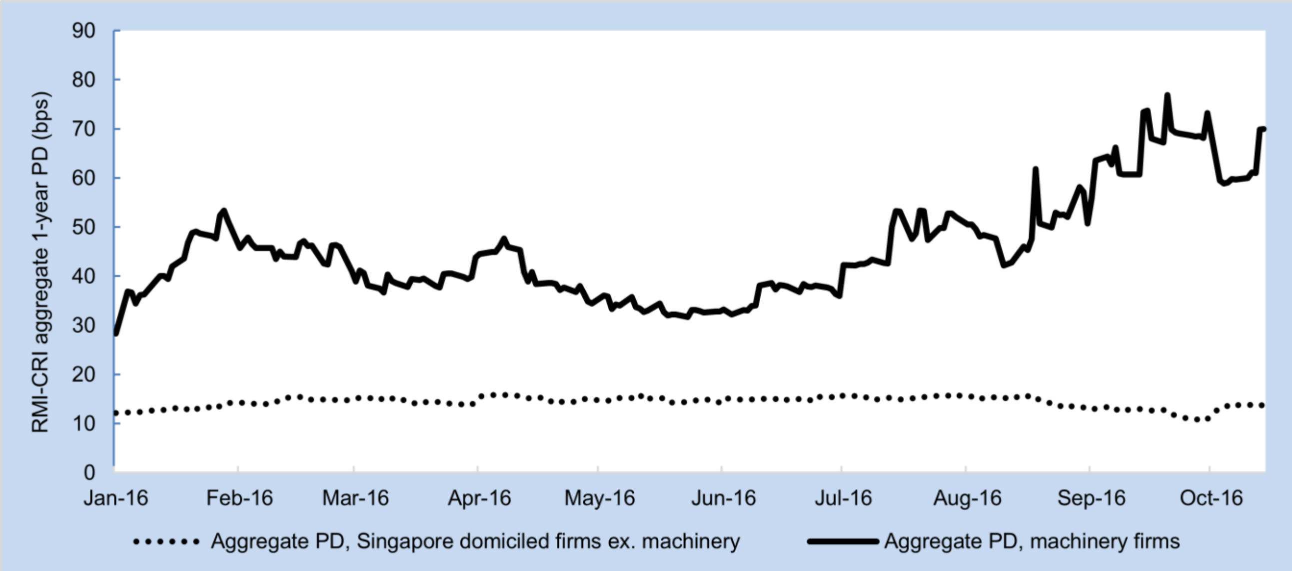

Figure 2: RMI-CRI 1-year aggregate PDs for Singapore domiciled firms. *Source: RMI-CRI*

Our sample of 22 machinery firms accounts for over SGD 1bn of market capitalization and approximately SGD 743mn of debt. Most of the corporates are small cap firms with less than SGD 400mn in market value with two overseas companies having a market cap over SGD 450mn. The range of 1-year PDs within the sector is very wide as 59% of the 17 companies that report PDs on Oct 14 have 1-year PDs of more than 60bps, while 18% have a 1-year PD of less than 2bps.

None of the 22 firms defaulted during 2016 although two companies delisted from the Singapore Exchange due to merger activity. Both acquisition targets were among the largest companies in the machinery industry and their corporate transactions coincided with a material improvement in credit quality prior to the announcement of the deals. Interplex Holdings, a precision engineering company was acquired by Baring Private Equity Asia for SGD 450mn from CVC Capital Partners and Standard Chartered Private Equity. The deal was announced in Dec 2015 and completed in March this year. Prior to the deal announcement, the RMI-CRI 1-year PD for Interplex dropped from 34bps in March 2015 to 8.84bps on Dec 23, 2015. China International Marine Containers Group acquired Pteris Global after its 1-year PD improved from a record high of 194bps on Nov 6, 2015.

The machinery sector is likely to face continued headwinds from weak equipment demand and disruptive machine engineering technologies. Last Wednesday, policy makers announced new initiatives to speed up reform in the precision manufacturing industry with the first digital factories expected to be built by 2017, but it remains to be seen how the new technologies would affect current players. Companies may have to invest in new equipment to keep up with new trends, but do not have sufficient capital for research and development. Existing machinery firms have cited poor margins from rising labor costs, pricing pressures and a weak end user market.

* Only sectors with more than 9 firms with 1-year PDs on Oct 14, 2016 were considered in the study. The firms were grouped according to Bloomberg's BICS Level 2 classification.

Credit News

Lending Club tightens credit policies in fight to keep investor demand

Oct 17. Lending Club has once again tightened its credit policies in the recent half year, as the platform battles to sustain investor demand, while rising delinquencies among lowest-ranked loans have cut net returns. Last Friday the company announced that it would stop lending to certain classes of very risky customer and would increase rates for everyone else, after greater than expected losses across the board. Lending Club's move comes in the wake of the launch of a rival service from Goldman Sachs, which threatens to pick off some of Lending Club's more creditworthy customers, many of whom are looking to refinance debt racked up on credit cards. Compared with online lending platforms, Goldman's new venture, Marcus, provides relatively cheap and sticky funding and flexible payback terms and rates. (FT)

Negative rates threaten to deflate crucial Japan leasing sector

Oct 17. Japan's leasing sector has become an unintended victim of the country's negative interest rate policy aiming to stimulate the sluggish economy. The sector took a battering by a sharp drop in pricing power and a decrease in transaction volume. According to Capital Economics, the ongoing slowdown in services inflation and the drop in inflation expectations highlight that the benefits of its aggressive policy easing are increasingly elusive. The flattening of the Japanese government bond yield curve, which lowers the rate customers are charged but prevents leasers from cutting funding costs, has led the BOJ's services producer prices index to fall in July and August. In addition, leasing companies are also suffering from a decline in transactions, as the monetary easing policy failed to stimulate consumer spending. (FT)

Jamaica gets new USD 1.7bn IMF agreement after slashing debt

Oct 14. Jamaica and the International Monetary Fund has reached an agreement to make USD 1.7bn available over the following three years. Under the new agreement, Jamaica would receive USD 430mn immediately after approval from the IMF board in the next month. The new agreement would replace a four-year IMF loan that Jamaica took on after it restructured debt in 2013. According to Prime Minister Andrew Holness, the government has ample foreign reserves and aims to treat the new agreement as "an insurance policy against unforeseen economic shocks" which includes natural disaster and slumping commodity prices. (Bloomberg)

China Construction Bank to set up debt restructuring fund with Wuhan Steel

Oct 12. China Construction bank will establish a CNY 24bn transformation and development fund for Wuhan Iron and Steel Group Corp. According to the bank, the fund is set up to help the steel firm reduce leverage and is the first of its kind which involves a central government administered state-owned enterprise. The steel company has already received its first injection of CNY 12bn and from official media China Daily. The reduction in leverage would be accomplished through debt-to-equity swaps. Based on a news briefing, a high-level official mentioned that loss-making "zombie" firms are excluded from such swaps with such swaps used mainly to aid high-quality firms that face temporary difficulties. (Reuters)

Ireland plans to cut debt as it braces for Brexit

Oct 11. The Ireland government has established a tough new target to reduce debt and outlined measures to cope with the consequence of UK leaving the European Union. Growth is expected by the government to pace the rest of the Eurozone for this year and next, although at a slower rate than before. Still, due to Ireland's close trading and financial links with the UK, Ireland is vulnerable to fallout from the Brexit vote. Minister of Finance Michael Noonan had set the new national target for government debt at 45% of economic output, well under the EU's upper limit of 60% which was crossed by many of the EU bloc's member government. According to Mr Noonan during his sixth budget speech, the Ireland government aims to achieve its target by "the mid-2020s or thereafter depending on economic growth."(WSJ)

Singapore says neutral policy to stay as economy shrinks (Bloomberg)

European bond funds hit by largest outflow in more than a year (FT)

Bank of Korea holds interest rates steady as debt soars (Bloomberg)

Regulatory Updates

Basel committee announces new global capital rules for bank bonds

Oct 12. The Basel Committee has announced measures designed to limit the amount of bank bonds held by other banks, as part of new rules to redistribute the risk of financial failure. The rule, which applies to globally systemic banks, aims to prevent the kind of taxpayer bailout that happened during the global financial crisis by transferring the risk to investors in bank bonds. Basel confirmed that, subject to a certain threshold, banks will take a hit to their capital if they hold a certain amount of other banks' debt. (FT)

Basel to give banks more time to phase in loan provision rules

Oct 12. Basel suggested banks be given three to five years until new accounting rules (IFRS 9) for loan losses have an impact on regulatory capital. Although Basel still welcomes the change in principle, it said banks may have to raise provisions as a consequence and hence should be given more time to phase them in. Currently both IASB and FASB have both adopted standards that measure the expected credit loss for any loan, rather than the incurred loss of loans that turn sour. The IFRS 9 will take effect in 2019 for IASB and in 2020 for FASB. (Bloomberg)

French plot revolt over new European rules for failing banks (FT)

Hong Kong regulator probes accounts of China Fiber Optic (Bloomberg)

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