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Weekly Credit Brief Oct 13 - Oct 19

Valeant seeks relief from market concerns

by Li Chenxue

Valeant Pharmaceuticals International Inc. (Valeant), a Quebec-based drug maker with a market cap over USD 80bn, saw its share price plunge over 7.7% on Monday after it claimed to shift from the pivotal business strategies that had built up the company's success, amid criticism of high drug prices.

Valeant is known for its aggressive expansion strategy through acquisitions instead of investing in research and development (R&D). From the beginning of 2015 to date, the company has acquired 7 companies and still has 4 pending deals. In 2014, the company only spent 3% of its revenue on R&D, compared to 15% to 20% of its peers. After the acquisitions, Valeant tends to axe most of the employees from the acquired companies to cut costs and significantly raises the prices of the drugs acquired. One recent example would be Salix Pharmaceuticals, which was acquired by Valeant in February this year. After the acquisition, Valeant raised the price of Glumetza, Salix's diabetes drug, by 800%.

This strategy has propelled Valeant's success. Its stock was one of the best performers in the pharmaceutical industry in recent years, and its sales had grown more than six-fold due to a series of deal-makings. However, this business model has encountered some obstacles lately. On Sep 22, Hillary Clinton, the Democratic presidential candidate, rolled out a plan to crack down on the high prescription drug prices in the US, attracting public attention to the steep price hikes in the drug industry. Last week, Valeant received subpoenas from the federal prosecutors regarding its drug pricing and the financial aid it gave to the patients. Moreover, Valeant has piled up heavy debt mainly caused by its aggressive deal-making strategy. The company's total debt almost doubled from USD 20.9bn in Q4 2014 to USD 41.8bn in Q2 2015. Besides, the total debt to equity ratio was 280% in 2014, much higher than the approximately 100% range of most of its peers.

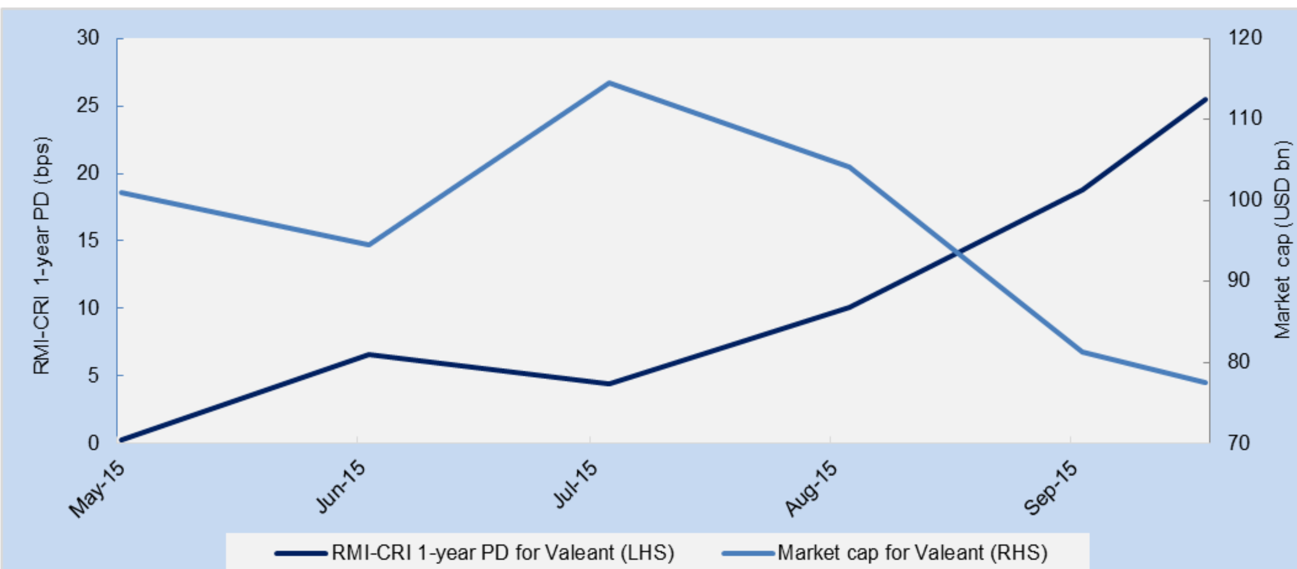

Figure 1: RMI-CRI 1-year probability of default and market cap for Valeant. *Source: RMI-CRI, Bloomberg*

To address the issues surrounding its high debt, Valeant CEO Michael Pearson recently said that the company is going to pay down its debt rather than to keep doing aggressive acquisitions. And the company will shift focus to R&D and might spin off its neurological drug segment, which heavily relies on price increases. Yet the investors are worried that the company will not be able to achieve its previous pace of growth without doing deals and then raising the price of the drug acquired. Figure 1 shows that the market cap of Valeant has seen a roughly 23% drop since the beginning of September. And, the RMI-CRI 1-year Probability of Default (PD) for Valeant rose from around 5bps in early August to 25bps in October in tandem with the plummeting market cap, revealing a deteriorating credit profile.

Overall, the ongoing investigation could further turn investors away and might come with some penalties. Valeant's business prospects remain uncertain as it will still take time to see whether Valeant's strategic shift to internal growth can take effect as expected.

Credit News

Sinosteel bond investors hope for bailout as default looms

Oct 18. Sinosteel, a major Chinese state-owned miner and steel trader, is poised to default on its subsidiary's bonds on Tuesday last week. As China's leadership is reluctant to tolerate public defaults due to fears about financial instability, Sinosteel investors are hoping that the government or another state entity will step in with a bailout. However, analysts warn that the bailout could promote moral hazard and misallocation of capital. (FT)

China economic growth falls below 7% for first time since 2009

Oct 18. China's economy has decelerated to its slowest pace since the global financial crisis and has added concerns for the outlook of world economy. The 6.9% growth rate for the third quarter, announced on Monday, clouds China's prospects for reaching the official targeted growth rate of about 7% for the year. It also renews pressure on Beijing to enact more pro-growth measures. Economists expect the central bank will cut interest rates at least once and further reduce banks' required reserves before the end of the year. (WSJ)

Corporate America's epic debt binge leaves USD 119bn hangover

Oct 15. High-grade companies tracked by JPMorgan Chase incurred USD 119bn in interest expenses in 2014, which is the highest level since 2000. Concurrently, companies' ability to service debt is at the lowest since 2009, according to data from Bloomberg. Historic low interest rates have spurred companies to load up on debt and the deterioration of the balance sheet will worsen if earnings growth continues to stall. As a result, it has become expensive for even the most creditworthy companies to borrow or refinance. (Bloomberg)

World's biggest leveraged ETF halts orders on liquidity concern

Oct 15. Nomura Asset Management will halt subscription orders for its Next Funds Nikkei 225 Leveraged Index ETF and two other funds from Oct 16, 2015. The money manager said that the lack of liquidity prohibits the fund from meeting its target. Surging inflows from individual investors have made the Nikkei 225 ETF one of the biggest players in Japan's futures market, sparking concerns that the fund's trades are exacerbating price swings. Following the subscription halt, the fund will continue to accept redemptions and trades normally on the Tokyo stock exchange.(Bloomberg)

Default looms for Chinese solar company

Oct 13. Defaults in China were once again spotlighted when a solar component maker missed a bond payment last week. It manifested the nation's debt market flashes danger signs like equities did before their tumble began four months ago. Baoding Tianwei Yingli New Energy Resources Co., whose majority holder was until last year the world's biggest solar panel company by shipments paid only RMB 643mn out of RMB 1bn of principal due, falling into a default on the bond issued in 2010. As a matter of fact, slowing economic growth is adding to strains in China's bond market of RMB 42.2tn, which now has had five defaults this year. (Bloomberg)

China ponders tool deemed too risky post 2008 to cut bad loans (Bloomberg)

China liquidity trap deters funds (SCMP)

Wal-Mart surprises market with dim outlook (WSJ)

Regulatory Updates

Indian banks face huge Basel III challenge

Oct 18. According to two research institutes, ASSOCHAM and NIBM, India's banking sector is expected to face huge challenges of meeting the globally mandatory Basel III banking norms by Mar 31, 2019. With the assumption of at least 20% credit growth in the short to medium term, the study estimates that the public sector banks alone will require close to USD 20bn of capital strengthening to meet the Basel III requirements. Given the dismal performance shown by majority of the public sector banks in recent years, it will be difficult for them to raise so much capital. Even worse, raising non-equity capital through Tier 1 and Tier 2 bonds is also a painful choice, as the India's domestic Tier 1 and Tier 2 bond markets are limited, whereas resorting to overseas bond could push up the cost of capital, and thus impair the banks' profitability. (Gulf News)

ECB sets higher capital hurdle for Greek banks in stress tests

Oct 13. A new capital threshold has been implemented by the European Central Bank (ECB), which top Greek banks have to meet in a stress test tougher than the initial euro zone wide health checks. This would mean that these banks have to increase their capital by billions of euros. The ECB is testing Greece's four largest banks in order to give a rough gauge of how much capital they need after the recent economic crisis in Greece. (Reuters)

Switzerland said to impose 5% leverage ratio on banks

Oct 13. Switzerland's finance minister is proposing for the country's largest banks to comply with a too-big-to-fail rule based on US standards. This rule demands for the Swiss banks to hold capital equal to about 5% of total assets, where Swiss government will align its calculation of the ratio based on the method employed in the US. Top Swiss banks will need to add billions of equity to their buffers or shrink their activities, in order to meet the new requirements and have argued that Swiss financial system is not comparable with the US. Regulators are currently fine-tuning this proposed rule, which the government has yet to approve. (Bloomberg)

FCA orders fresh scrutiny of spread betting (FT)

Treasury abandons senior bankers' accountability rule (FT)

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