Credit Research Initiative
NUS National University of Singapore | RMI
transforming big data into smart data
Weekly Credit Brief Sep 22 - Sep 28

Weak pricing on white pigment puts Tronox on rocky footing

by KHAW Ker Wei

The RMI-CRI 1-year Probability of Default (PD) for Tronox, a member of the Russell 2000 index, hit an all-time high of 479bps on 24 September 2015 (see Figure 1), since its emergence from Chapter 11 proceedings more than four years ago. Tronox is the world's largest, fully integrated producer of titanium feedstock and titanium dioxide (TiO_2), a white pigment used for the production of consumer products ranging from paint coatings to food colorings. A highly specialized business, Tronox derives greater than half of its annual revenue from pigment sales. The softening of the TiO_2 market has therefore, weakened the company's financial strength considerably.

High margins and the anticipation of strong demand for TiO_2 at the turn of the first decade of the 21st century spurred industry players to ramp up their production capacity. However, the global economy slowed heading into the mid-2010s and the subsequent increase in TiO_2 production created an oversupply that squeezed profit margins. The global demand-supply imbalance was further disrupted by new entrants into the market – TiO_2 producers from China. The Chinese production has been able to meet industrial requirements in recent years and its supply to the global market has suppressed TiO_2 prices. Furthermore, industrial buyers of TiO_2 have also found ways to cut the amount of the pigment needed in their products. As a result, Tronox's annual gross profit dropped from almost 30% in 2011 to only 11.9% at the end of 2014.

The shifting market conditions has already triggered a wave of business consolidations and acquisitions in the industry. In October 2014, competitor Huntsman completed the acquisition of Rockwood's TiO_2 business unit for USD 1.1bn to become the second largest producer of the commodity in the world. More recently, and probably with a higher degree of significance, the two largest producers in China, Henan Billions and Sichuan Lomon Titanium, merged in August 2015 to form the fifth largest TiO_2 producer globally, knocking Tronox off the position in the process. Given the tight market conditions, industry analysts believe that the industry is unlikely to recover before 2017.

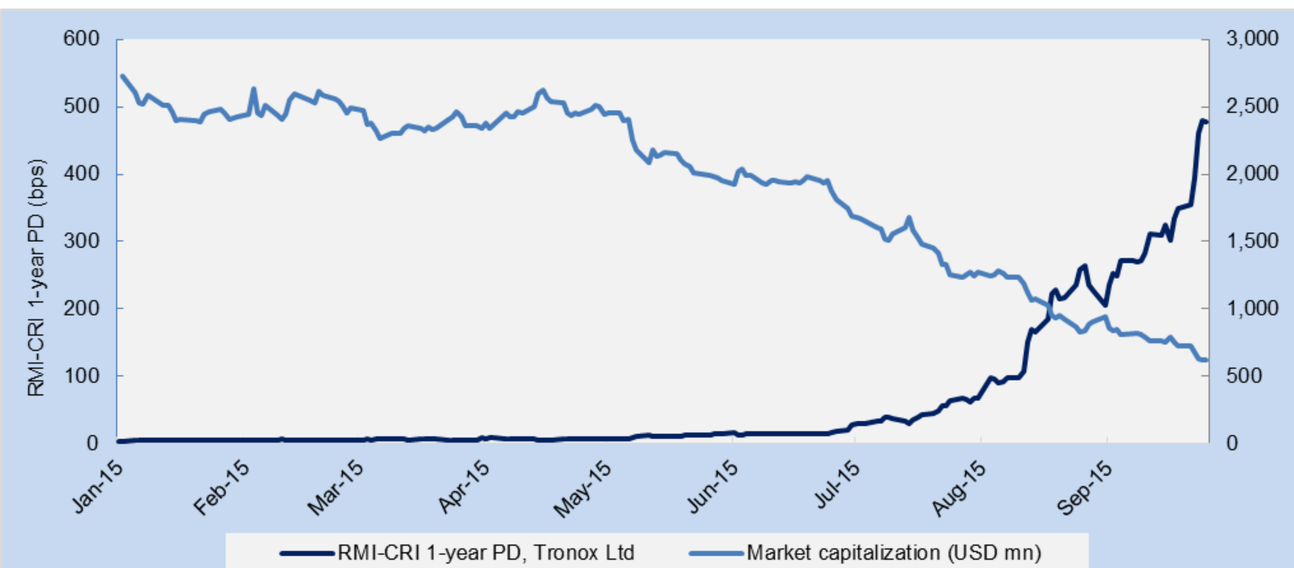

Figure 1: RMI-CRI 1-Year PD for Tronox against its market capitalization. *Source: RMI-CRI, Bloomberg*

Tronox appeared to have played a different card in response to its competitors. Instead of acquiring other businesses to drive up its TiO_2 capacity, the company purchased Alkali Chemicals, the largest and lowest cost producer of natural soda ash, from FMC Corporation for USD 1.64bn. The transaction came to a close on 1 April 2015. By expanding into complementary markets, Tronox was able to diversify its business exposure, though it remains to be seen if the strategy would help it see through this difficult period. The company funded the acquisition with approximately USD 1bn in cash and about USD 600mn in new debt. Post-acquisition, the debt to total assets ratio of the company grew to 0.56, from 0.26 at the end of 2011. In contrast, the world's fourth largest producer of TiO2, Kronos had a debt to total assets ratio of only 0.25 as of the end of June 2015. Kronos has not been involved with any merger and acquisition activities.

Tronox's fully-integrated structure allows its pigments segment to acquire titanium feedstock at lower cost, translating into higher gross margin compared to other non-integrated peers. However, with the prevailing dynamics in the TiO2 market, the company continues to report weak revenue growth in the pigments segment. The key driver to reducing the leverage ratio of the company would, therefore, come from Tronox's alkali segment. The newly acquired business is expected to generate an after-tax cash synergy of more than USD 30mn during the first year, growing to over USD 60mn by year three – effectively utilizing the tax attributes that the company has been granted with, through a legacy legal settlement.

Year	2011	2012	2013	2014	Q2 2015
Total Debt / Total Assets	0.26	0.30	0.42	0.47	*0.56*
EBITDA / Interest Expense	12.30	3.63	2.58	2.22	*0.48*

Table 1: Selected financial ratios for Tronox. *Source: Bloomberg*

Even though Tronox's liabilities do not come attached with maintenance covenants as of the third quarter of 2015, the interest expense may prove to be a significant burden to the company. Its EBITDA to interest expense ratio fell sharply to just 0.48 in Q2 2015, from 1.65 the previous quarter. Tronox paid in excess of USD 130mn on interest expense in 2014. The new debt issued to acquire Alkali Chemicals, which carries a coupon rate of 7.5%, would increase its annual interest expense by more than USD 40mn thereafter. To make matters worse, a leading credit rating agency lowered the company's debt rating by one notch at the beginning of September 2015. Tronox estimated that the downgrade would put an additional USD 3.7mn to its interest cost annually.

Concerns over the company's liquidity, coupled with weak revenue performance from its TiO2 segment, has sent Tronox's share price plunging in the second half of 2015. Tronox had USD 2.7bn in market capitalization at the beginning of 2015. By 25 September 2015, it has shrunk to a mere USD 618mn. While Tronox has already drawn up a plausible debt reduction program, the company's current financial strength remains in doubt. The acquisition left it with only USD 205mn in cash and cash equivalents as of the end of Q2 2015. The USD 405mn revolver facility that it has may help it see through any immediate cash needs but it would not do much to improve its credit profile.

At the beginning of September 2015, the management reiterated its commitment to achieve a positive free cash flow status in 2016 and reduce Tronox's net leverage ratio to a healthier level in 12 to 15 months. Under such difficult circumstances, the management will have to exercise great discipline to meet these goals.

Sources:
Tronox, Quarterly Results
RMI-CRI
Bloomberg

Credit News

Saudi Arabia withdraws overseas funds

Sep 28. Saudi Arabia has withdrawn tens of billions of dollars from global asset managers as the oil-rich country seeks to cut its widening deficit and reduce exposure to volatile equities markets amid the sustained slump in oil prices. The country's foreign reserves have slumped by nearly USD 73bn since oil prices started to decline last year as the country keeps spending to sustain the economy and fund its military campaign in Yemen. (FT)

Volkswagen suffers as buyers abandon its debt

Sep 27. In addition to the potential fines levied on Volkswagen, the company has been paying the price of its emissions scandal, as investors abandoned its bonds, driving up the company's borrowing cost. It has been speculated that the ECB has stopped buying the company's bonds that are backed by car loans and had been bought as part of the quantitative easing package. Earlier in the year, VW could borrow long-term funds for as little as 0.7%. Now the yield on those bonds is up to 2.3%, indicating that investors believe the company is now a riskier bet. Due to the plummeting sales, the big three ratings agencies have warned they are considering cutting the car giant's score, a move which would push up borrowing costs even further. (Telegraph)

Chinese debt market heats up

Sep 27. China's domestic corporate-bond market has rallied on Beijing's aggressive monetary easing and a crashing stock and real estate market that has drawn investors into the relative safety of bonds. The clamor for corporate bonds in China is enabling lots of financially vulnerable companies to issue debt at the lowest yields in five years. Property developers, considered among the riskiest companies in China, have sold a total of 237 billion yuan worth of bonds so far this year, up by 72% YoY. According to China Securities Credit Investment, the most aggressive borrowers tend to be the ones that need money to save their lives rather than to expand their businesses. (WSJ)

Thai banks face biggest default since '97 as steel venture fails

Sep 25. Sahaviriya Steel Industries Plc, the Bangkok-based operation of Southeast Asia's largest flat-steel manufacturing complex, reneged on USD 1.4bn of loans on Monday following the failure of its four-year UK venture. The default events this week have inflicted the biggest default on Thai bankers since the Asian financial crisis. Should all of Sahaviriya Steel's debt become nonperforming, bad loans in the Thai banking system will rise to 2.86% of total advances, up from 2.46%. However, according to Bank of Thailand, this event will not affect the stability of the overall financial system; given the lenders of Sahaviriya have already set aside some provisions. (Bloomberg)

Taiwan cuts rate for first time since 2009 as exports falter

Sep 24. Taiwan has lowered its policy rate for the first time since the global financial crisis, sending forwards on the island's currency to a six-year low. The central bank cut the benchmark discount rate by 12.5bps to 1.75%. Taiwan's economy is slowing down as its technology exports are weighed down by increased competition from China, where growth is also moderating. According to some economists, the move, which comes ahead of an anticipated rate increase from the US Federal Reserve, may not be the last. (Bloomberg)

Gulf rig supplier may be first to exit oil-slump bankruptcy (Bloomberg)

Ireland shows how to ski down the debt mountain (WSJ)

Sharp drops to record low after saying it will miss profit goal (Straits Times)

Regulatory Updates

'Strong deleveraging' risk in Norway prompts regulator warning

Sep 28. The head of the Norwegian Financial Supervisory Authority has warned that a plunge in housing prices might lead to deleveraging effects in the real estate market and damage the economy. Low interest rates and a boom in oil prices have inflated Norwegian housing prices over the years. Debt levels are at a record high and borrowers now owe lenders about twice their disposable incomes. Economists warn that if GDP growth falters, the elevated debt levels may aggravate the downturn. (Bloomberg)

Kremlin said to urge Basel III delay as economic crisis deepens

Sep 27. Russia's Finance Ministry has urged the central bank to delay the implementation of Basel III rules, which require Russian lenders to raise capital requirements with effect from January 1, 2016. Officials are afraid that the stricter Basel III rules would tighten credit conditions further as banks allocate more reserves to meet regulatory standards and restrict corporate lending. The banks' earnings have declined as the economic recession has taken a toll on the firms' bottom line. The proportion of bad loans has increased as lenders continue to struggle in a worsening business climate. (Bloomberg)

Liquidity rules proposed on outflow fears

Sep 22. US financial regulators have asked the public to comment on a new rule to ensure that mutual funds and exchange traded funds have sufficient liquidity during high redemption periods. Under the new SEC rule, open-ended funds have to ensure that investors can liquidate their holdings on any business day and receive payment within seven days. It is also the responsibility of fund managers to guarantee the availability of liquidity without affecting the asset's price. Regulators are concerned that many bond fund investors, may trigger a sharp rise in bond yields after they redeem their holdings once US interest rates start to rise. (FT)

Bankers invited to lobby as Denmark opens door to laxer rules (Bloomberg)

S.E.C. turns its eye to hidden fees in mutual funds (New York Times)

Published weekly by Risk Management Institute, NUS | Disclaimer
Contributing Editor: Victor Liu