CRI Credit Research Initiative
Risk Management Institute, National University of Singapore
NUS National University of Singapore | RMI Advancing Risk Management for Singapore and Beyond
transforming big data into smart data
Weekly Credit Brief Jul 04 - Jul 10

Brazil's electric utility company goes all out as economy makes progress

by Budi Andoro HARTANTO

September 11, 2012 marked a historical event in the Brazilian electric utility industry when the then president, Dilma Rousseff, announced a change in rule governing the automatic concession extension for companies involved in electric power generation and transmission. Referred to as Provisional Measure 579 (MP579), the decree detailed that companies whose hydropower generation and transmission concessions that were expiring between 2015 and 2017 were advised to renew those concessions earlier than the usual 20-year period. It would also require energy companies to abandon free pricing and reduce electricity prices for industrial and residential consumers. This dealt a severe blow to many local power companies as it stripped them of their freedom to plan their investments strategically. The change came at a time when Brazil had been experiencing severe droughts that limited hydropower output and forced generation and transmission companies to purchase electricity from other thermoelectric plants at unprofitable prices.

Cia Energetica de Minas Gerais (CEMIG), Brazil's third largest power utility, was one of the companies that refused to extend three concessions linked to its São Simão, Jaguara and Miranda hydropower plants, which generate 35% to 45% of its revenues. CEMIG instead decided to extend the concessions under the conditions before the MP579 decree, but ended up in a legal dispute over the three plants with the government due to an alleged reason of failing to conform to MP579. Furthermore, as Brazil plunged into economic recession in mid-2014 due to a huge budget deficit, weak consumer demand created a sudden oversupply of electricity. This was further exacerbated by above-average rain in the following period that filled hydroelectric dams, causing electric spot prices to fall and hurting electric distribution enterprises across Brazil, including CEMIG's electric distribution business, which were required to sell the surplus in the spot market under long-term contracts. All of these most likely pressurized CEMIG to resort to bond issuances and massive bank borrowings to finance its operation. CEMIG's outstanding bank loans and other obligations have tripled to BRL 13bn since 2012.

Currently, CEMIG is facing short-term liquidity issues as many of its bonds issued are maturing in the near future. As of March 31, 2017, the company faced BRL 4.3bn of debt maturing in 2017, BRL 3.9bn during 2018 and maturing obligations related to a put option contract of approximately BRL 1.6bn, which compares to a cash & cash equivalents positions (including short-term investments) of only around BRL 1.7bn (see Table 1). To add, 80% of CEMIG's debt is due by 2019. Its Net Debt/EBITDA, a financial leverage metric, has been high above 3.5X since Q1 2016 with its value peaking at 4.74X during Q2 2016 (see Figure 1). CEMIG's level of Cash from Operations as a multiple of average current liabilities, a measure of the company's ability to finance its liabilities without incurring additional debt, has been steadily decreasing since Q3 2014, with its value hitting rock bottom at -0.01X during Q4 2016 (see Figure 1). This would suggest the company's increasing dependence on bond issuances and bank loans to finance its maturing debts and liabilities.

	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017
Revenue (BRL mn)	4453.50	4754.10	4894.30	4672.60	4812.90
Cash, Cash Equiv. & STI (BRL mn)	1989.0	2432.70	2604.10	2009.30	1683.30
Operating Margin (%)	11.72	6.61	18.74	5.41	18.35
EBITDA (BRL mn)	721.10	514.0	1119.90	485.90	1084.80

Table 1: Financial Data for Cia Energetica de Minas Gerais (CEMIG). *Source: Bloomberg*

Nonetheless, not all is lost for CEMIG, at least for now. The Brazilian central bank's hard work to push for more spending and higher inflation came to fruition when the economy emerged from recession in Q1 2017 following a series of gradual and calculating cuts in interest rate by the central bank with a bullish outlook on the economy. This not only helps to restore confidence in the economy, but also allows debt-dependent CEMIG to incur less interest expense from bank borrowings and reduce constraints in its balance sheet.

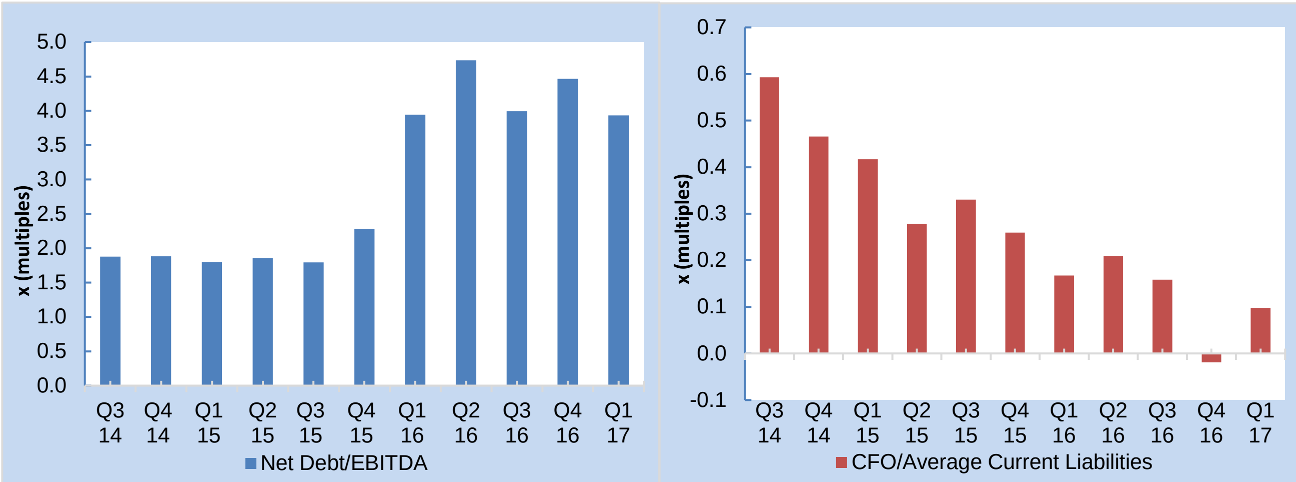

Figure 1: Net Debt/EBITDA & Cash From Operations/Average Current Liabilities for Cia Energetica de Minas Gerais (CEMIG). Source: *Bloomberg*

Also, ever since right-wing Michel Temer took over the country's number one spot, he has been pushing for deregulations in businesses and openness in the economic and trade sector. One notable example is the signing of a law to ease utilities privatizations, allowing for economic efficiency in the local market. The law would also allow power generation firms to freely sell their output for higher tariffs for undetermined periods, cut subsidies to renewable energy sources while widening customer access to power purchases in unregulated markets. Doing so enabled distressed energy utility companies, including CEMIG, to sell off their assets to relieve some of their financial obligations. CEMIG has been selling its assets and divesting its stakes in other companies ever since. On June 2017, it plans to go all out by selling assets worth BRL 6.5bn to shore up its finances. Those assets consist mainly of hydroelectric dam assets, a telecom subsidiary, a natural gas distribution unit and stakes in a transmission company. As shown in Figure 2, the RMI-CRI 1-Year Probability of Default (PD) for CEMIG has somewhat improved over the shown time period, the lowest value was recorded at 51.20 bps during mid-March 2017, coinciding with the period where CEMIG has been going for divestitures and asset sales.

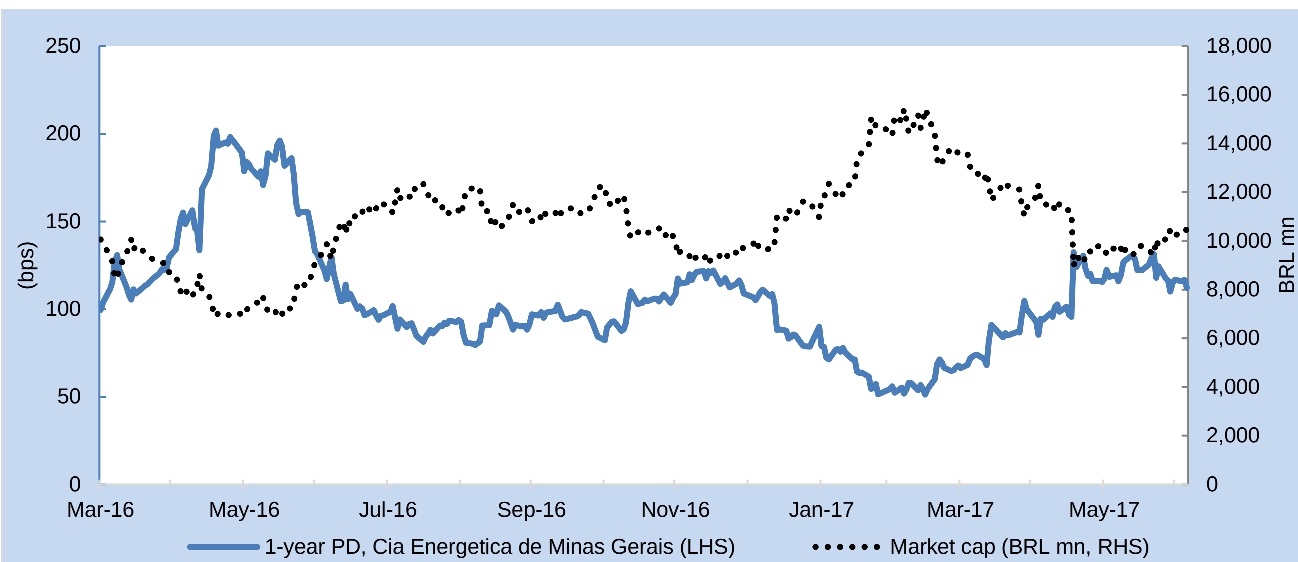

Figure 2: RMI-CRI 1-year PD for Cia Energetica de Minas Gerais. vs market capitalization. *Source: RMI-CRI, Bloomberg*

The problems CEMIG faces are remnants from the MP579 decree during Rousseff's time as president and are unlikely to be encountered again unless the new government introduces unaccommodating regulations. It is still early stage to conclude that CEMIG has secured a bright future ahead and it cannot possibly rely on the same strategies to finance its operation and obligations in the longer term. Furthermore, Brazil's recovering economic condition is still in its infancy and its ongoing political instability may likely affect investment climates in the near term. Nevertheless, pro-business reforms and improving economic situations are set to be key turning points for CEMIG as they herald Brazil's comeback just when it is about to play a larger role in the international stage and solidify its position as one of Latin America's largest economies.

Credit News

Canadians brace for higher interest rates after years of cheap debt

Jul 10. Bank of Canada is expected to raise interest rates next week, when the economy is still facing a number of headwinds, such as weak inflation and the expected renegotiation of the North American Free Trade Agreement (NAFTA). The first interest rate hike in seven years would bring about an increase in borrowing costs. In the past few years, many Canadians have been carrying debt due to relatively low interest rates. (Reuters)

Warning signs emerge in the UK car loan market

Jul 9. Growth of car loans in UK has rocketed over the past few years, which triggered alarm among regulators. According to the Finance and Leasing Association, British households borrowed a record GBP 31.6bn in 2016 to purchase cars, an increase of 12% compared with a year before. The sharp increase in car loans was spurred by personal contract purchase plans. Now there are concerns of an economic crash if borrowers come under pressure from a rise in interest rates and unemployment. Last month, the Financial Conduct Authority has launched a review into the motor finance industry to see whether it needs regulatory intervention and the Bank of England has ordered banks to set aside larger capital buffers in case the market deteriorates. (FT)

UBS and Credit Suisse cut back on domestic mortgages

Jul 9. Switzerland's two largest banks have both decided to reduce their market share of domestic mortgage market due to concerns over ultra-low interest rates and mounting property prices. The two banks accounted for 27.4% of the Swiss mortgage market in April 2017, down from 28.2% the year before. Market shares of the cantonal and the Raiffeisen bank have been expanding in the meantime. Both UBS and Credit Suisse expressed their decision to pursue quality growth strategy focusing on sustainable risks and returns. The UBS real estate bubble index rose into the risk category during the first quarter of this year, highlighting increasing risk in the property market. SNB's main policy interest rate is currently at -0.75%, but the negative rates have not been passed on to retail customers by the Swiss banks due to fears of a bank run. (FT)

China's USD 162bn of dealmaker debt raises alarm

Jul 5. Chinese companies, including HNA Group Co. and Fosun International Ltd., have accumulated a total debt of USD 162bn due to their aggressive acquisitions overseas, of which USD 11.5bn is due by the end of 2018. Aggressive acquisitions have prompted a government intervention, making it difficult for companies to repay their loans. In addition, the local bond market rout has raised cost of refinancing companies' liabilities. These events have sparked worries amongst global banks and investors, which in turn held back on their investments. (Bloomberg)

French PM warns of more cuts to tackle country's debt 'volcano'

Jul 4. The French prime minister Edouard Phillippe has vowed to cut public spending to stem France's intolerable reliance on state borrowing, which he said had left the country dancing on a debt volcano, indicating that the debt had reached unsustainable levels. Instead of the notion of one-size-fits-all austerity, he insisted that the plan of the new centrist president was to reduce public spending while launching a EUR 50bn investment program and cutting a range of taxes to boost businesses. France's public debt totaled EUR 2.1tn, nearly a year's economic output. The government aimed to bring its deficit within the EU limit of 3% GDP by this year. It is expected that the move would win the trust of his partner Germany and persuade the country to keep embarking on reforms of the bloc. (The Guardian)

Big US banks' profit forecasts take a fall (FT)

Sovereign wealth fund GIC warns investors aren't fearful enough (Bloomberg)

Illinois rushes to enact budget to avoid junk rating (Bloomberg)

Regulatory Updates

Singapore to delay market risk rules for banks, Reuters says

Jul 6. The Monetary Authority of Singapore (MAS) notified banks of its decision to delay the implementation of the fundamental review of the trading book (FRTB) by a year. The FRTB was introduced by the Basel committee to control trading risks undertaken by banks to prevent a repeat of the 2008 financial crisis. However, complexities and technical clarifications in the new standards resulted in regulators delaying its implementation as they align the new structure with their individual jurisdictions. Apart from Singapore, Australia and Hong Kong have announced delays in implementation as well. Meanwhile, Europe and the US remain in a deadlock over a revamp of BASEL III capital standards. (Bloomberg)

Indian panel seeks comments on new bankruptcy code

Jul 6. The Indian government has asked the public to comment on the new Insolvency and Bankruptcy Code implemented last year to overhaul the old insolvency framework for Indian firms and individuals. The Reserve Bank of India Act was recently amended, empowering the central bank to instruct lenders to begin insolvency proceedings against individual bad loans. The new bankruptcy legislation is a historical development for the Indian economy, but lawyers say problems still exist within the framework. For example, borrowers do not have the opportunity to get a fair hearing before court proceedings are admitted to the tribunals. (Business Times)

Pakistani finance minister criticizes central bank over rupee plunge (Reuters)

BOI instructs banks to analyse risk of credit to auto industry (Bank of Israel)

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