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World's biggest meat processor tainted by scandals

By Liu Hanlei

Managed by the Batista brothers, JBS SA grew from a Brazilian slaughter house to become the world's largest meat processor. However, JBS and its management also managed to set another record – the company paid the world's biggest leniency fine of BRL 10.3bn for its role in a corruption scandal involving Brazil's President Michel Temer. Joesley Batista, the Chairman of the firm resigned and stepped down from JBS shortly after the scandal was exposed. JBS' market capitalization has dropped by nearly 39% since the start of the year and the RMI-CRI 1-year Probability of Default (PD) for JBS increased to 217bps on June 9 (see Figure 1).

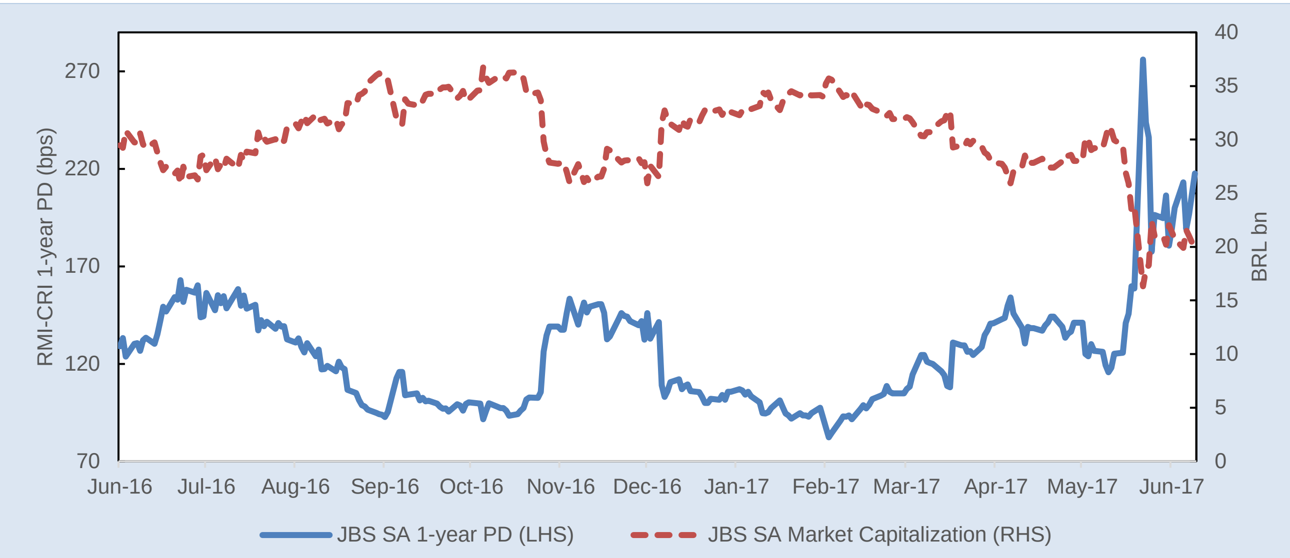

Figure 1: RMI-CRI 1-year PD for JBS SA (left axis) and market capitalization (right axis) *Source: RMI-CRI, Bloomberg*

The corruption scandal involving JBS' chief and Brazil's President is not the only ongoing investigation. JBS, its holding company, J&F Investimentos, or its executives have been named for 6 different corruption investigations in Brazil over the past year. In Mar 2017, JBS was involved in a corruption scandal with food-safety inspectors, termed Operation Weak Flesh, which alleged that meatpacking plants in Brazil including JBS bribed food-safety inspectors to approve meat exports to Europe and China without inspection. The scandal affected the reputation of the Brazilian beef business as major importers began imposing limits on Brazilian supplies. JBS' CEO, Wesley Batista, said in the Q1 2017 earnings call that the repercussions from Operation Weak Flesh had reduced demand, increased cost and lowered sale prices causing operating margins to fall from 4.9% to 2.9% in Q1 2017, and affect Q2 2017 results.

	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017
Revenue (BRL mn)	43,911	43,671	41,166	41,630	37,616
Operating Margin (%)	2.07	4.1	4.63	4.94	2.9
EBITDA/Interest Expense (x)	2.13	3.02	3.15	3.48	2.35

Table 1: Financial Data for JBS SA. *Source: Bloomberg*

JBS' leverage should also be noted as its net debt to equity ratio stands at 187% and its EBITDA to interest expense ratio declined to 2.35x as of Q1 2017. JBS' consolidated cash of BRL 10.7bn combined with its revolving credit lines of BRL 4.3bn provides 0.84x coverage of its BRL 17.8bn short term debt (representing 30% of its total debt) maturing over the next 12 months, mainly related to trade-finance loans. There are concerns that the scandals may limit JBS' funding options as banks are restricted from lending to companies facing corruption charges. State-controlled lender Caixa was instructed not to refinance existing credit line to J&F Investimentos and Caixa is its largest creditor with outstanding loans amounting to BRL 9.7bn. Analysts have also estimated that the fines levied to JBS by Brazilian public prosecutors might amount to BRL 5bn and there are yet unknown fines from regulators from other countries. Provisions for these fines have yet to be accounted for based on Q1 2017 financial statements as civil provisions only amount to BRL 280mn. The fines are expected to have a negative impact on its balance sheet and credit profile. Fitch Ratings has downgraded JBS' credit rating from BB+ to BB due to potential fines, the reduced access to funding which may hurt its ability to repay its short-term debt and the increase in reputational risk. One of JBS' customer, Domino's Pizza Brazil has confirmed that it will stop getting supplies from JBS for its 184 restaurants across the country.

In order to reduce its leverage and shore up liquidity, JBS sold its weak Argentine operations to its rival for USD 300mn. However, the management mentioned that no core assets would be sold. JBS' initial public offering of its international unit would most likely be postponed due to the scandals. Analysts are predicting that JBS would need to enter some form of restructuring or asset disposal program to survive as funding and liquidity tightens. Furthermore, analysts are also skeptical that there would be buyers for the large assets JBS holds given the potential anti-trust issues.

JBS' reputation has been damaged from the corruption investigations and food safety scandal. The damage to JBS' sales may persist as consumers place a high importance on food standards and safety. With falling sales, potentially more fines and operating with high leverage, JBS will need to do more to survive the crisis.

Credit News

Russia confirms Venezuela defaulted on USD 1bn

Jun 11. The audit chamber of Russia was forced to amend Russia's federal budget down by USD 1bn after Venezuela defaulted on its obligations. The default was uncovered by reporters from RBC in Russia and was later confirmed by the audit committee. A loan of USD 4bn had been extended to Venezuela for the purchase of Russian defense products in 2011. The debt had previously undergone two restructurings in 2014 and 2016 respectively. Up till 2015, regular payments had been made for the loan. However, problems started arising in 2016 after Venezuela failed to repay USD 265mn on the main debt in March and subsequently postponing repayment of USD 530mn in September, citing liquidity crisis in the country. (Latin American Herald Tribune)

Rescue of Spain's Popular is the start of Europe's banking test

Jun 9. Spain's Banco Popular bailout measure by European regulators was met with mixed responses as the incident became the first to be tested on using the newly revamped rule on rescuing failing European banks. European financial officials praised the rule change in providing a relatively swift regime in tackling Popular's problems without using taxpayer funds while leaving depositors and senior bondholders unscathed. Investors and analysts, however, maintained that the event did not represent a true test to the system because the bank was sold before a full resolution. Nonetheless, questions on why regulators were not quicker to spot Popular's impending crisis or to push the bank to raise capital earlier still abound. Meanwhile, complications seem to be arising in troubled banks across Europe, including the UK, concerning how the new regime deals with different problems posed by the banks. (FT)

Qatar debt rating downgraded by S&P as riyal hits 11 year low

Jun 8. Riyal hits its 11-year low due to Doha's diplomatic rift with Saudi Arabia, the United Arab Emirates, Egypt and Bahrain. These Arab states had accused Qatar of supporting terrorism. As a result, S&P cuts Qatar's long-term debt rating from AA to AA-. In addition, the rating is on CreditWatch with negative implications, hinting that there might be a further downgrade. S&P expects Qatar to experience slow economic growth due to reduced regional trade and damaged corporate profitability. The US dollar attained a bid price of 3.6526 against the riyal in the spot market on June 7 2016, the highest since July 2005. In the offshore forwards market, riyal fell to a record low of 550-point premium against the dollar since December 2015, implying that further depreciation of about 1.5% is expected in the next 12 months. S&P also noted that Qatar's banking system had been increasingly reliant on loans and deposits from Gulf and international banks, making it susceptible to major outflows. (Reuters)

Asian perpetual bond market fizzles to life

Jun 7. Perpetual bonds are becoming popular in Asia, particularly to Chinese companies that want the flexibility of extending their debt maturity over a long horizon. They also served to lock in borrowing costs, denominated in USD, before a presumed interest rate hike by the US Federal Reserve in the following week. This is followed by a strong demand for perpetuities by investors, insurance companies, and other institutions hoping to offset long-term liabilities. The Evergrande Group, a Chinese property developer, is an example of a company that made heavy use of perpetuities to partially minimize the amount of total debt shown on its accounts. The enterprise is now retiring all its perpetual debt as liabilities by paying an estimated average interest cost of 9.5%, sending its share price to an all-time high. Meanwhile, several Hong Kong corporations sold perpetuities without increasing their yield. These are viewed by investors as a way of diversifying their portfolios. (FT)

China bond finance hits record low as market rout hammers demand

Jun 7. Net Chinese corporate bond financing fell from RMB -89bn in February to RMB -217bn in May due to the discouragement of new issuance by a market rout while previously issued notes came to due. There is a significant fall in banks' demand for bonds due to the "regulatory windstorm" led by the new Chinese banking regulator and the People's Bank of China draining liquidity from the money market. In addition, investors are also cautious about the rising credit risk. This has resulted in the cancellation or postponement of 400 planned bond sales worth RMB 390bn in May this year, up from RMB 286bn last year. Tighter rules on bond investments have since been set in place as part of a broader effort to control risks from shadow banking. Increasing financing difficulty has severely impacted bond issuers of low quality and correspondingly increase their credit risks. In response, would-be bond issuers have been compensated with loans from both banks and non-bank lenders, leading to the increase in overall corporate and household financing for the first four months of this year compared to the year before. (FT)

China banks brace for June cash squeeze as fund costs jump (Business Times)

With 260-to-1 leverage, a Chinese giant takes on Goldman in repo (Bloomberg)

Regulatory Updates

Bill to erase some Dodd-Frank banking rules passes in House

Jun 8. As part of its campaign promises, the Trump administration is revoking certain financial regulations under the Dodd-Frank Act. The bill for the Financial Choice Act has been passed in the house and is now under the review of the Senate. If passed, the act will exempt certain financial institutions of capital and liquidity requirements set out by the Dodd-Frank to restrict risk taking. It will also replace Dodd-Frank's orderly liquidation authority with a new bankruptcy code provision. The move is expected to reduce Federal deficits by USD 24.1mn. The administration hopes that the Choice Act will unshackle businesses and generate growth, ultimately creating plentiful of jobs in the US economy. However, observers are pessimistic about the bill being passed by the Senate given the slim majority Republicans have in the Senate. Changes will have to be made to the bill before it becomes a law and the Senate is expected to preserve key components, such as the Volcker Rule, of the Dodd-Frank Act. (NYT)

EBA issues 2018 EU-wide stress test methodology

Jun 7. The resilience of European banks will once again be assessed against a macroeconomic baseline and adverse scenario using financial information at the end of 2017. The stress test is that of a constrained bottom-up approach, where individual lenders will be required to estimate the scenarios on their projected profits and capital position. The 2018 stress test will include IFRS 9, a stricter accounting standard for soured loans and exclude funds from incomplete asset sales. Similar to the 2016 stress test, the results of next year's assessment will not contain a pass fail threshold, but used as inputs into the Supervisory Review and Evaluation Process in 2018. (EBA)

Bank of Canada says uninsured mortgages pose increasing risk (The Globe and Mail)

Japan to rein in regional banks' overexposure to bonds (Nikkei Asian Review)

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