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Two car manufacture giants maneuvering through challenging times

by Tobias BEHRENS

Since the manipulation of pollutant emission measures among car manufacturers came up in September 2015 with its first culprit being Volkswagen AG, car manufacturers all over the globe were unintentionally brought to public attention. In addition, the current big players in the industry are not only concerned about reputational damages, but also about new competitors, which are about to change the shape of the industry. Those new peers are technology experts such as Google's parent Alphabet Inc., which is working on the evolution of self-driving cars, the car-sharing company Uber Technologies Inc. and the electric-car manufacturer Tesla Inc. Traditional carmakers need to pay attention to current market developments of those competitors in order to keep up with their new rivals.

Among these long-established manufacturers, Ford Motor Co. and Fiat Chrysler Automobiles NV are currently struggling not only because of strong competition in the industry and weakening US demand, but also because of firm-specific developments. On May 22, Ford Motor Co. replaced its former CEO Mark Fields, who run the company since July 2014, with Jim Hackett. The step surprised investors, as Hackett, former CEO of office furniture supplier Steelcase, is not an industry expert, although he was the chairman of Ford's Smart Mobility unit before the recent change. The situation at Ford was double-edged, so the management replacement only partly matched with recent quarter's financial figures as Ford was able to generate constant revenues and a decreasing debt position compared to its EBITDA (Table 1). The company also managed to cushion a 22% decline in US car sales and a 4% decline in total volume in Q1 with a 10% increase in US F-Series truck sales, showing support for Ford being able to deal with consumer's shift of taste in its most important market North America that accounted for about 66% of 1Q revenue and 45% of volume.

	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017
Revenue (USD bn)	37.72	39.49	35.94	38.65	39.15
Free Cash Flow (USD bn)	2.64	4.96	3.45	0.72	2.63
Net Debt/EBITDA (X)	N/A	N/A	-0.74	-1.01	-1.12

Table 1: Financial Data for Ford Motor Co. *Source: Bloomberg*

However, the company's RMI-CRI 1-year Probability of Default (PD) steadily increased since January 2017 from 72 bps to 178 bps on May 25 with a spike on January 31 as Ford reported a negative net income of USD -783mn in Q4 2016 (Figure 1). The PD further increased afterwards due to diminishing market capitalization of over 17% since the turn of the year, which was the reason for the management replacement. Investor sentiment turned negative when the recognized growth potential, especially related to new electric drive technology, declined. Sales underpin this skeptical view: Ford sold 26% fewer plug-in hybrids and electric vehicles than his competitor General Motors YoY through April. In addition, Ford has USD 8.7bn of debt maturing in 2017, which may lead to higher financing costs and the company has wider spreads on some short-dated bonds than General Motors. Moreover, Ford Motor Credit, responsible for Ford's leasing business, faces pressure from declined US vehicle sales volume that may result in losses in the lease portfolio. Ford forecasts USD 1.5bn in 2017 pretax income from financial services, the unit's lowest since recession.

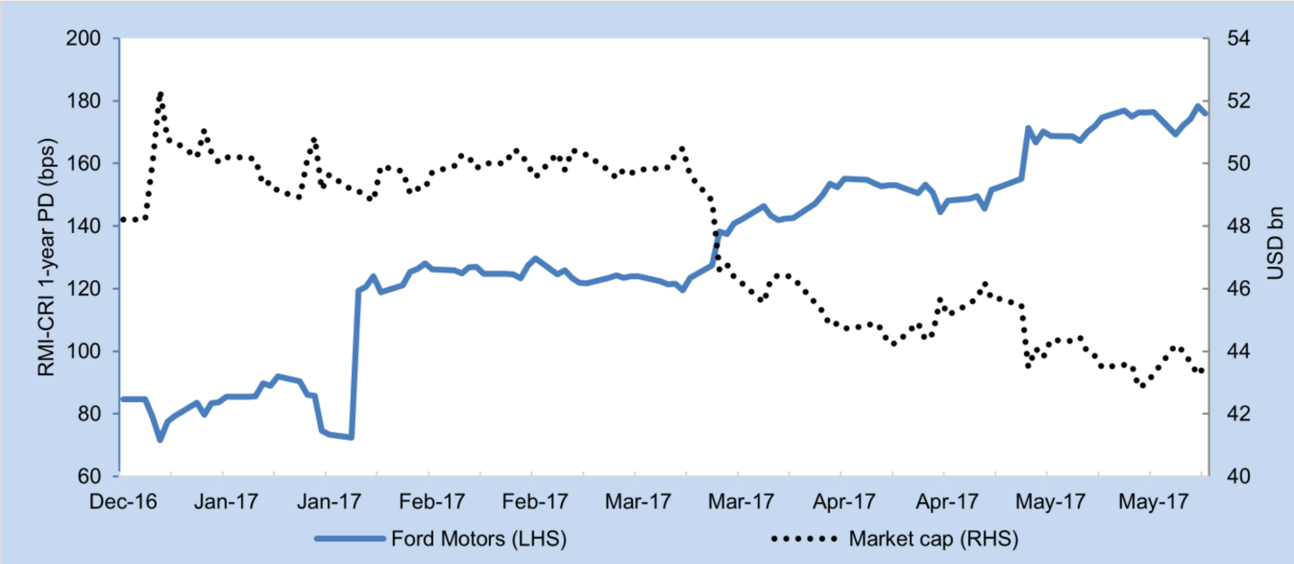

Figure 1: RMI-CRI 1-year PD for Ford Motor Co. vs market capitalization. *Source: RMI-CRI, Bloomberg*

Mr Hackett is expected to change the strategy and maneuver Ford in the direction of new motor innovations, ridesharing and self-driving vehicles given his former position at the Smart Mobility unit. In addition, he is known for cost cutting due to his cut of head count at Steelcase by 32% in the period 2000-04. Hackett is supposed to reduce USD 3bn in annual costs through 2020, which is a challenging goal, even after the recent elimination of 1,400 workers in North America and the Asia-Pacific region. Another option may be exiting some money-losing foreign markets in order to keep pace with competitors in developing smart mobility solutions. Such a market is South America, which generated losses for 14 consecutive quarters, totaling USD 3.4bn since 4Q13. Furthermore, Africa, the Middle East and South America generated USD 324mn in losses in Q1.

Fiat Chrysler's financial position appeared similar strong on the surface as Ford's, with stable revenues and operating margins and a reducing debt position, which is expected to be even further reduced by 2018 (Table 2). In addition, the firm plans to transfer USD 4.9bn industrial net-debt into USD 4.5-5.6bn net-cash. The North America performance in Q1 was stable. Net revenues and sales declined by 4% and 7% respectively, but this was due to the end of a product cycle and a transition to the new Jeep Compass model. Therefore, market share and margin stayed flat and new-vehicle sales were even at a record of 17.5mn in 2016. In Europe and Latin America net revenues increased by 5% and 12% respectively and only the Asia-Pacific region was struggling with revenue decreases of 32%.

	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017
Revenue (USD bn)	26.57	27.89	26.84	29.72	27.72
Free Cash Flow (USD bn)	-1.16	2.07	-1.29	2.32	-0.69
Operating Margin (%)	5.21	5.86	5.59	5.75	5.56

Table 2: Financial Data for Fiat Chrysler Automobiles NV. *Source: Bloomberg*

However, the future is challenging for Fiat Chrysler as sales in the US, its most important and most profitable market, fell for eight months in a row and in a same matter as Ford, the company tries to shift from cars to light trucks, which led to 40,000 fewer shipments in Q1, whereas revenues stayed flat. As a result, car sales fell 32% and light truck volume increased by 10% in 2016. Because of the shift, Fiat Chrysler plans to produce only light trucks in the US in 2017 and beyond. Another US problem is a potential US border tax, which may make the production in Mexico, which was about 97% high-demanded light trucks, unprofitable. In a same manner as Ford, Fiat Chrysler lacks in the innovation of new motor technologies. Its Fiat 500e, the only hybrid, recorded only 3,737 unit sales in 2016. Those problems coincided with a fall in market capitalization in March.

Nevertheless, all these problems appear small compared to the recent US lawsuit because of Diesel emissions that led to a drop in share price after a recovery from the March decline. The implications of this are still unknown, but Volkswagen paid more than USD 20bn over the past two years. VW's settlement averaged USD 15,671 per car after admitting guilt and estimates show a possible fine of USD 4.6bn. So far, Fiat Chrysler denies the manipulation and pursues approval for an updated emissions software, which it will distribute to its customers. For the car manufacturer the costs of unsold barred models such as its Diesel Ram pickup trucks, lost reputation and decreasing share prices might be exceptionally harmful. In combination with a potential fine, these issues may lead to an increase in the company's credit profile in the future. The risk arises from potential reductions in sales due to the reputational damage and further sales restrictions by the US Environmental Agency because of potential violations of the US Clean Air Act. This may further reduce the firm's free cash flow, which was already negative in Q1. In addition, potential criminal activities raise questions about internal control mechanisms and the corporate governance system, putting further pressure on the future development of Fiat Chrysler's creditworthiness and its financing flexibility.

Both companies chose a strategy relying heavily on light trucks, especially in the USA, instead of investing large stakes in new driving innovations. Competitors from the technology industries may be to small players nowadays and not able to provide mass-market cars for the middle class. However, prices for these cars may fall eventually and environmental regulations may help them to increase market share. Ford and Fiat Chrysler need to be aware of those long-term structural changes, although the current attention focuses on the establishment of a new management and the investigations into Diesel emissions.

Credit News

Reliance Communications extends tumble on concerns over debt

May 29. On May 29 the billionaire Anil Ambani's Reliance Communications Ltd. was reported to have defaulted on loan servicing obligations and Indian banks have put the company's loans into "special mention accounts," which means interest payments are overdue. The stock of Reliance plunged as much as 24% on the same day, hitting an intra-day record low of INR 19.70. It was the day's worst performer on S&P BSE500 index. And Reliance bonds plunged 17 cents and its shares tumbled 16%. The tumble mainly resulted from mounting concerns about the Indian phone carrier's debts. Reliance earnings have suffered as the company struggles to compete in one of the world's cheapest and most competitive mobile-phone markets. The company on May 27 reported its first-ever annual loss and said it's seeking waivers on some bank loan covenants. (Bloomberg)

Turkey applies to sell as much as USD 8bn in debt abroad

May 29. In an effort to further bolster growth through foreign borrowing, Turkey filed an application in the US to sell as much as USD 8bn in debt. Knowing that the Turkish government had exceeded its 2017 full year foreign currency debt target of USD 6bn, this action came as a surprise since the aggressive borrowing still did not manage to wane increasing demand in Turkey's sovereign bond market, which came after the central bank's effort to stem lira declines triggered a currency rally and drove yields above 11%. One money manager in an investment fund cited both the calm in markets and a decrease in the cost of Turkey's credit default swaps being the main drivers behind the happenings. Supporting the low Turkish CDS cost are the government's debt-to-GDP ratio at around 30% at the end of 2016, which is almost half its level a decade ago and its current cost below 200 bps, the lowest in more than two years. (Bloomberg)

Hong Kong finance chief questions Moody's over debt downgrade

May 28. A recent cut in China's sovereign debt rating led Moody's to downgrade its rating on Hong Kong's local- and foreign-currency issuances from Aa1 to Aa2, due to the contagious nature of the risk posed by China's on Hong Kong's financial market since both areas have close economic, financial and political ties. This was met with criticism by the Hong Kong's government, which was represented by Financial Secretary Paul Chan. Chan cited not only Moody's baseless claim on China's economy, but also the fact that strong cooperation with mainland China should instead be viewed positively as China is the main growth engine for the global economy. Furthermore, he added that the rating agency overlooked Hong Kong's different aspects of having strong economic fundamentals, robust financial regulatory regime, resilient banking sector and strong fiscal position which can help ease Moody's "contagion channels" worry. (Bloomberg)

Moody's lowers China credit rating as growth slows

May 25. Moody's Investor Services has downgraded China's credit rating for the first time in almost three decades, on concerns that the financial strength of China's economy is likely to deteriorate in the comping years as growth slows and national debt keeps climbing. In addition to cutting China's long-term currency rating to A1 from Aa3, Moody's also changed its China outlook to stable from negative. Moody's sees China's growth potentially declining to near 5% over the next five years despite mounting debt burden. However, China's authorities claimed that Moody's was exaggerating the country's economic difficulties and underestimating reform efforts. (Straits Times)

Chinese developers surge in Hong Kong as Evergrande hits record (Bloomberg)

Bankrupt Westinghouse ends pensions for ex-CEOs, executives (Channel NewsAsia)

Creditors cry foul after default as Azeri bank offers debt swap (Bloomberg)

Regulatory Updates

USD 4tn exchange traded fund industry draws more scrutiny

May 27. With the growing importance of ETFs in global financial markets, the International Organization of Securities Commissions (Iosco) is considering new ways to govern this USD 4tn industry. This is part of Iosco's efforts to strengthen resilience in capital markets globally. A total of USD 2.6tn were poured into ETFs over the past decade. Net new inflows to Blackrock's iShares ETFs reached USD 89bn, with no signs of slowing down. Doubts are raised as to whether ETFs can cause price bubbles and be damaging towards the efficiency of stock markets. Despite ETFs playing a bigger role in financial markets, Blackrock denied that ETFs could be destabilising and claim investor sentiments as the real market driver. High fees and poor performance of actively managed mutual funds are also causing investors to switch to passively managed ETFs. (FT)

Italy's Veneto banks given state guarantee over liquidity

May 26. The Italian government is backing up troubled lenders to instill confidence and maintain liquidity in these banks. Both the EU and Italy's Treasury hope to ensure the stability of Veneto banks while safeguarding the interests of savers. Under such context, authorities want to prevent a "bail-in" where bondholders, investors and depositors must first bear losses before state funds are used. The two Veneto banks are struggling as the surge in bad loans is compounded by a mis-selling scandal which resulted in a flight of account holders. It is estimated that the two Veneto banks must fill a EUR 6.4bn capital shortfall after a combined loss of EUR 3.6bn in 2016 that pushed their capital below minimum thresholds. State aid, however, cannot be used to offset losses incurred by the bank. (FT)

Banking watchdog warns of rising household credit in Israel

May 24. Israel's banking supervisor warned on May 24 that the levels of household credit in the economy were rising and the banking sector was suffering from over-regulation that needs to be halted. The central bank showed in 2016 that the number of private customers having difficulty repaying their debts increased and the bank's credit losses in the area of retail credit increased to the relatively high level of 0.85% of credit. Israel's household debt is 14% of gross domestic product which is still reasonable by international comparison. The central bank of Israel has already issued instructions to banks to curb their appetite for risk and to check households in a holistic manner before granting credit. (Time of Israel)

Chinese regulator tightens rules to pace substantial shareholders' stake disposals (SCMP)

Basel III reforms package closer to being finalised (FT)

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