Weekly Credit Brief

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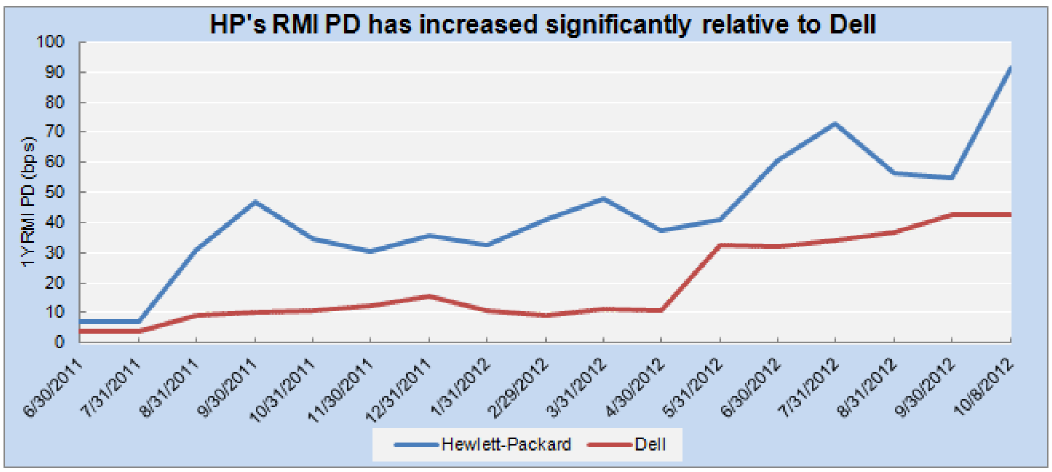
Story of the Week

HP riskiest in a decade relative to Dell

By James Weston

The 1-year RMI probability of default (RMI PD) for US-based Hewlett-Packard (HP) reached the highest level in almost 10 years last week, as the company struggles with a corporate restructuring and high debt levels. The RMI PD for HP is now 49.1bps higher than that for leaner competitor Dell, the most in a decade, after being lower 18 months ago. RMI PDs imply that the credit profiles of both firms are currently much worse than credit rating agencies (CRAs) suggest.



Although both companies have suffered from weakening consumer and corporate demand for IT hardware, Dell has been more successful in focusing on cloud computing services and associated hardware. Moreover, Dell's overall healthier financial profile is reflected in a lower RMI PD. HP's relatively higher RMI PD reflects comparatively lower liquidity, higher overall debt levels, and increasing interest costs, along with investor concern about restructuring efforts.

RMI PDs imply lower ratings: The company's 1-year RMI PD of 91.6bps on October 8 implied a Ba1-equivalent rating, four levels lower than Moody's current A3 rating, and similar to the Ba2 rating implied by CDS prices. Moody's placed HP on negative watch on October 4. Fitch downgraded the company to A- from A on October 5; S&P has maintained a BBB+ rating on HP since November 2011.

Dell's 1-year RMI PD of 42.5bps on October 8 implied a Baa2-equivalent rating, three levels lower than Moody's current A2 rating. Dell is rated A by Fitch and A- by S&P. The company has been on stable outlook at all three CRAs since 2007.

Consumer and Corporate demand: Both companies have seen revenues and margins fall in their consumer PC and laptop businesses, due to increased consumer demand for tablets, including Apple's iPad, and increasing competition from Asian manufacturers. Printing and imaging units have also come under pressure, as consumers make use of social networks including Facebook and cloud computing to share images with each other.

A weakening business outlook in Europe, as well as a slowdown in China, threatens to weigh upon both companies' corporate business units. On September 10, JPMorgan cut its expectations for 2012 global IT spending to 1.9% YoY growth, down from a previous forecast of 2.2%. The introduction of Windows 8 is unlikely to drive a surge in IT purchases, as companies are unlikely to upgrade until the platform is mature.

Offsetting poor hardware sales: Dell has managed to offset declining personal computing revenues by focusing on selling servers and storage machines to large companies, amid surging demand for cloud computing. HP is currently undergoing a multi-year restructuring plan to simplify business processes and increase innovation, in order to address what CEO Meg Whitman believes is a lack of "competitive focus."

The plan is expected to generate savings by reducing hardware lines, lowering headcount levels and optimizing business processes. However, so far HP has been forced to use restructuring savings to offset a deteriorating outlook, instead of reinvesting into new business opportunities, much-needed R&D and internal IT, according to a HP presentation to securities analysts.

Financial profiles: HP's restructuring plan is aimed at turning around recent poor financial performance. Operating income after interest expense fell 24.9% year-on-year at HP to USD 1.9bn during the quarter ending July 31, and fell 23.2% year-on-year at Dell to USD 838mn in the quarter ending August 3. However, Dell's cash levels remained high at USD 11bn on August 3; cash levels at HP increased slightly to USD 9.5bn on July 31. These figures translate into cash to total asset ratios of 8% for HP and 26% for Dell.

HP has a much higher level of outstanding debt, with USD 11bn of bonds maturing through 2014. Dell has 2.4bn in bonds maturing over the same period. Moreover, HP currently has insufficient liquid assets to meet current liabilities, with a quick ratio of 63% at the end of July. Dell reported a quick ratio of 105% on August 3. Moreover, HP's leverage continued to increase through the quarter ending July 31, as the company's total debt increased to 3.5 times 12-month trailing EBIT. The same ratio for Dell remained stable at 2.2 times on August 3.

Analysts expect HP will need an additional USD 2bn to 4bn of debt, and refinancing could be costly. HP is unlikely to benefit from a recent decline in yields on US corporate bonds. Yields on HP's 10.5-year 4.05% bond remained close to 4% on October 8. Similarly-dated US corporate bonds currently yield 2.86%. Moreover, the yield on Dell's 10-year 4.625% bond closed at 3.17% on October 8.

Sources:
HP debt at riskiest level to Dell in decade (Bloomberg)

In the News

Indian Oil Corporation first Indian non-bank to raise debt in SGD
Oct 6. Mumbai-based refiner Indian Oil Corporation will become the first non-bank Indian company to issue SGD-denominated bonds, with SGD 400mn of 10-year bonds to be issued on October 15. The company priced the notes to yield 4%, lower than the 5.6% the company paid on 10-year USD-denominated bonds issued in 2011. Indian Oil increased the issuance size from SGD 300mn due to overwhelming demand. This was likely due to a reduction in tax rates foreign investors pay on interest earned on Indian bonds in September, and an ongoing hunt for yield amongst SEA investors. (Times of India)

Japan's central bank keeps interest rates unchanged, says economy 'leveling off'
Oct 5. The Bank of Japan (BoJ) left its key interest rate on hold and made no changes to its asset buying program, resisting pressure from the government for further easing. The BoJ said it expected inflation in the world's third-largest economy to "level off" to 0%. The BoJ also urged that more attention be paid to the impact of financial and foreign exchange markets on the economy. A strong JPY has severely impacted Japanese manufacturers, who are already struggling amid weak domestic and foreign demand. (Washington Post)

No Relaxation of Bank Capital Targets: EU Watchdog
Oct 3. The European Banking Authority (EBA) said it would stick to current bank capital targets, after some banks suggested capital buffers should be reduced. EU banks had to meet a core Tier 1 capital ratio of 9% before June; 27 banks increased their combined capital by EUR 94.4bn, but seven banks still required government help to meet the target. Banks will need to raise further additional capital before January 2013, when the minimum buffer of 7% required under Basel III comes into force. Even though the minimum buffer under Basel III is lower than 9%, the additional capital requirement would be the result of tighter capital definitions under Basel III. (CNBC)

RBA cuts rate to 3.25% as mining-driven growth wanes
Oct 2. The Reserve Bank of Australia (RBA) resumed reducing its benchmark interest rate, cutting the overnight cash-rate by 25bps to 3.25%, after leaving rates on hold for the previous three months. The RBA said the peak in the resource investment will likely occur in 2013, and at a much lower level than previously expected. Moreover, slowing growth in key export markets, signs of weakness in the labor market and subdued inflation meant an easing of monetary policy was prudent. A majority of economists surveyed by

Bloomberg are predicting another 25bps cut on November 6. (Bloomberg)

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