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Weekly Credit Brief

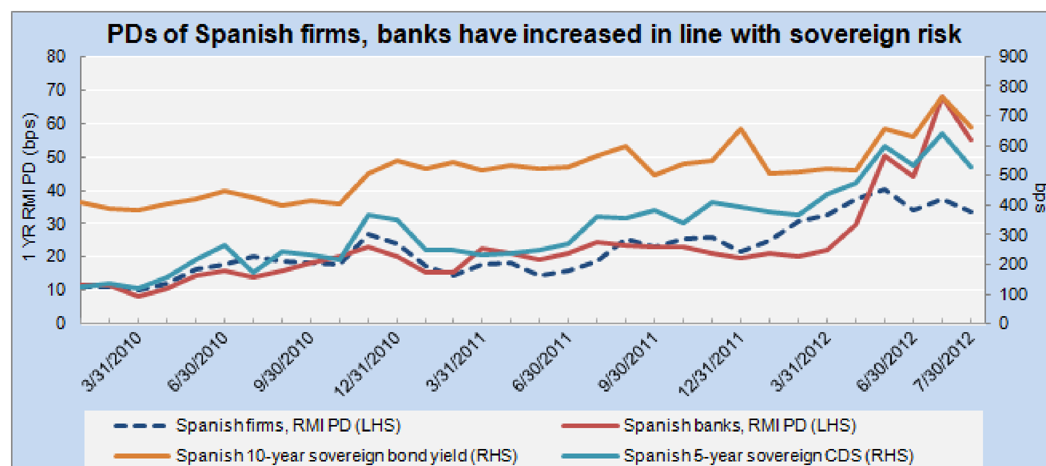
Jul 24 - Jul 30 2012

Story of the Week

Sharp spike in Spanish yields translate to heightened credit risks for Spanish banks

The aggregate 1-year RMI probability of default (RMI PD) for both Spanish firms and banks remained elevated last week, as yields on Spanish government bonds reached euro-era highs on July 24. Spanish benchmark 10-year government bond yields rose to as high as 7.62% on July 24, while 2-year yields rose to 6.78%. Yields on short term bonds have risen more than yields on longer term bonds, flattening the yield curve.

Investors have become increasingly fearful that Spain may lose access to debt markets and need a formal bailout, which may reach EUR 300bn in addition to the EUR 100bn in bailout funds recently approved for the Spanish banking sector. Spanish sovereign yields eased somewhat on July 26, after ECB President Mario Draghi said that the ECB is ready to do whatever it takes, within its mandate, to preserve the stability of the eurozone. Although he did not mention any specifics, market participants believe this involves large scale purchases of Spanish bonds by the ECB and eurozone bailout funds to ease market yields.



Corporates: Concerns about a potential Spanish sovereign bailout weigh upon the credit profiles of domestic firms while the economy slows, as the ability of the government to support the real economy may be drastically reduced under potential bailout terms. Reflecting this, the Spanish stock market plunged to its lowest level since April 2003 on July 24. Moreover, stubbornly high yields on government bonds continue to affect the funding profiles of Spanish firms.

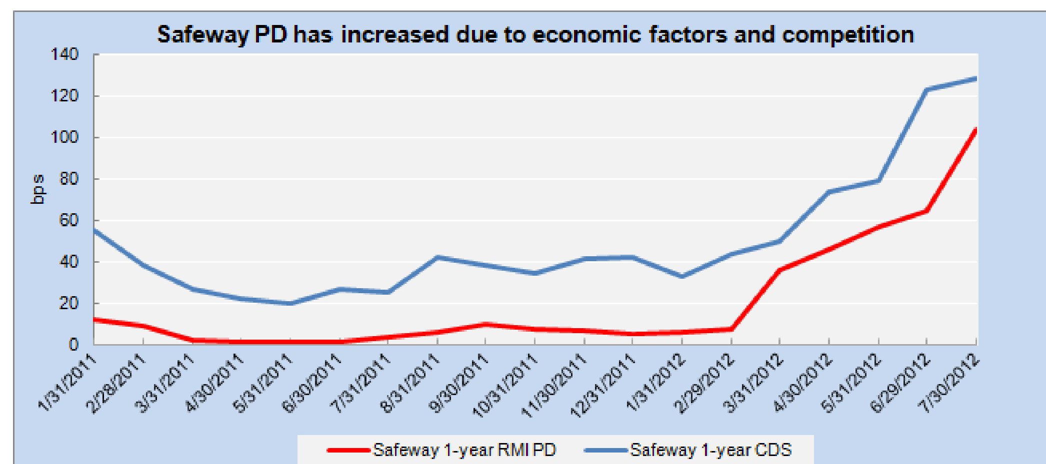
Banks: The slowing economy has also negatively affected the credit profiles of Spanish banks, with a record high unemployment rate threatening to further increase non-performing loans. Banks are also exposed to sovereign event risk, as they would likely suffer losses on large holdings of domestic bonds, while their cost of borrowing has become interlinked with government yields. This relationship is reflected in the increasing correlation between the aggregate RMI PD for the Spanish banking sector and market measures of sovereign risk.

Sources:
Spanish government bonds dive on bailout fears (Reuters)
Spanish yields edge back towards euro-era highs (WSJ)
Spain borrowing costs push still higher rattling eurozone (Channel News Asia)
Spanish debt risk jumps to record, credit-default swaps show (Bloomberg)
Spanish debt auction reflects brittle position (New York Times)

Macro-economic factors, intensifying competition, and weakened fundamentals weigh on Safeway's credit outlook

The aggregate 1-year RMI probability of default (RMI PD) for US-based Safeway has increased substantially

since February as the firm faces business challenges amidst a weak US economic environment. In addition, competition in the big-box retailer industry continues to increase, placing pressure on margins. The company has taken steps to regain market share through a new loyalty program, but questions remain about the company's business outlook, given recent leverage increases and shrinking margins. RMI PD data shows Safeway's credit profile began to weaken in February. The RMI PD for Safeway increased from 7.7bps on February 29, to 103.5bps on Jul 30. One-year credit default swaps tied to Safeway increased by 84.8bps, from 43.4bps on February 29, to 128.2 bps on Jul 30.



Challenging macro-economic factors: A weak economic environment in the US has curtailed consumer spending, weighing upon the supermarket industry. With QoQ GDP growth at 0.5% in Q1 2012, down from 0.7% QoQ growth in Q4 2011, and the unemployment rate increasing to 8.2% in June, from 8.1% in April, these factors, amongst others, have led to a change in spending patterns. Lower disposable incomes and food inflation have also resulted in volume declines.

Competitive pressures: Amidst intensifying competition in an already crowded marketplace, traditional supermarket channels face declining new store opportunities while alternative channels like supercenters, discount clubs and dollar stores continue to gain traction and increase their market share. Market watchers estimate that traditional supermarkets now account for about 51% of grocery sales, down from 66% in 2000. AC Nielsen expects that the market share of supercenters, discount clubs, and dollar stores will continue to increase going forward, growing at a Compound Annual Growth Rate (CAGR) ranging from 4.6% - 4.9% between 2010 and 2016. Despite a projected CAGR of around 1.5% between 2010 and 2016, supermarkets are expected to continue to lose market share.

Will the plan to capture customer loyalty work? Safeway recently launched an internet-based digital couponing and loyalty program called "just for U", with the objective of providing personalized special offers based on the each customers' past purchasing patterns. The program should make couponing more customer friendly and increase the connection between customers and producers. However, this program could lead to lower pricing, thereby creating incremental margin risk if the top line volume does not accelerate. Concerns remain regarding customer adoption, despite company representatives recently saying the company is planning to capture 60%-70% of customers through the new scheme, within two to three years.

Leverage: Safeway boosted its leverage to a seven-year high after selling USD 800mn of bonds in November 2011, and arranging a USD 700mn term loan to help fund share repurchases and payments on USD800m of debt maturing August 15, 2012. The company's long-term debt to equity ratio has increased from 1.24 times on December 31, 2011, to 2.35 times on June 16, 2012.

Facing challenging times: Volatile commodity prices and management aversion to passing higher costs on to consumers has resulted in margin pressures. Safeway reported a gross margin decline of 26bps YoY in Q2, while the companies operating margin declined by 9bps YoY. Both of these margins exclude fuel sales. Moreover, net earnings declined 16.4% YoY in Q2. One-time "just for U" rollout costs and additional advertising to support the broader business weighed upon both margins and net income. In addition, interest expenses increased to USD 73.5mn in Q2 2012, from USD 61.5mn in Q2 2011, as leverage increased, curtailing earnings

Sources:

Safeway profit drops amid growing competition (Bloomberg)
Safeway default swaps climb to record as profit declines (Bloomberg)
Safeway Inc. announces second quarter 2012 results (WSJ)

On the Call: Safeway CEO speaks on loyalty program (Bloomberg)

In the News

China opens biggest bond market to more overseas investors
Jul 27. The China Securities Regulatory Commission (CSRC) announced that it would allow participants in the Qualified Foreign Institutional Investor (QFII) program to buy bonds in interbank markets. Before this change, participants were restricted to bonds listed on Chinese exchanges. In addition, international investors will be permitted to purchase bonds issued by SMEs in private placements. The moves followed an increase in the quotas allotted to each QFII in April, to USD 80bn from USD 30bn, although half of the quota must be invested in equities. The ultimate goal of the changes is to open China's fixed income markets to overseas investors, and reduce domestic companies' reliance on bank loans. (CSRC, Bloomberg)

Egan-Jones cuts credit ratings of Spain and Italy
Jul 25. NRSRO Egan-Jones downgraded the Italian government's credit rating to CCC+ from B+, citing the current recession in Italy, struggling regional governments, and an ailing banking sector. Yields on Italian bonds have jumped in recent weeks on contagion fears as concerns mount Spain could need a sovereign bailout. Egan-Jones previously downgraded the Spanish government to CC+ from CCC+ on July 20. The ratings agency said that it expects austerity-related riots in Spain, and that several Spanish regions are likely to request financial aid from the Spanish government. According to Egan-Jones, investors holding bonds issued by weaker Spanish banks will be forced to take losses, and there may be some loss sharing amongst the banks. (Fox Business, Reuters)

US DOJ and SEC investigating potential violation by S&P
Jul 26. The McGraw Hill Companies, the owner of S&P, disclosed that it is being investigated by the US Department of Justice (DOJ) and the SEC over possible violations in connection with S&P structured product ratings. This followed a previous disclosure in September 2011 that S&P was being investigated by the SEC over ratings assigned to the Delphinus CDO 2007-1. While S&P did not reveal which ratings the DOJ probe relates to, should the DOJ and SEC ultimately file charges against S&P, it would mark the first enforcement action against any of the three major CRAs. Many market participants blame Fitch, Moody's and S&P for fueling the global financial crisis by assigning glowing ratings to complex structured products. (Reuters)

Correction: In the second line of paragraph 4, 'employment' has been replaced by 'unemployment' on August 1.

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