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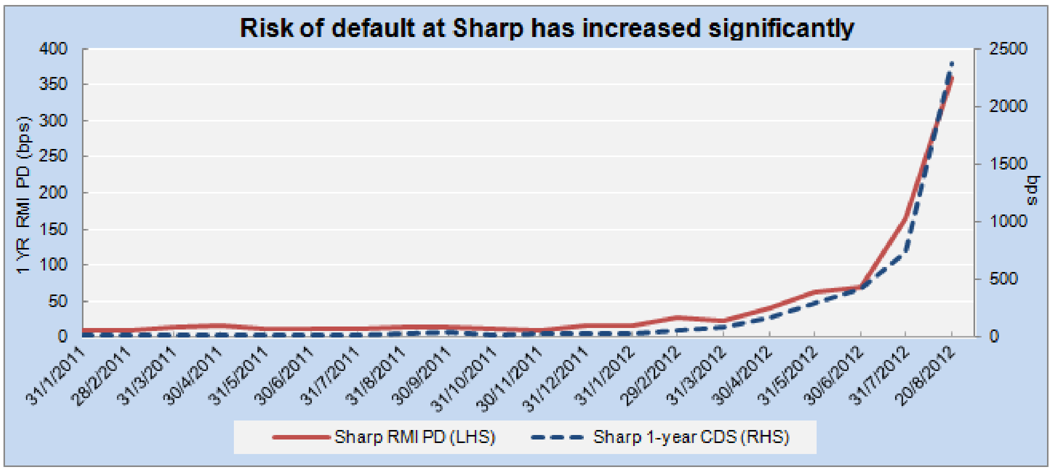
Weekly Credit Brief

Aug 14 - Aug 20 2012

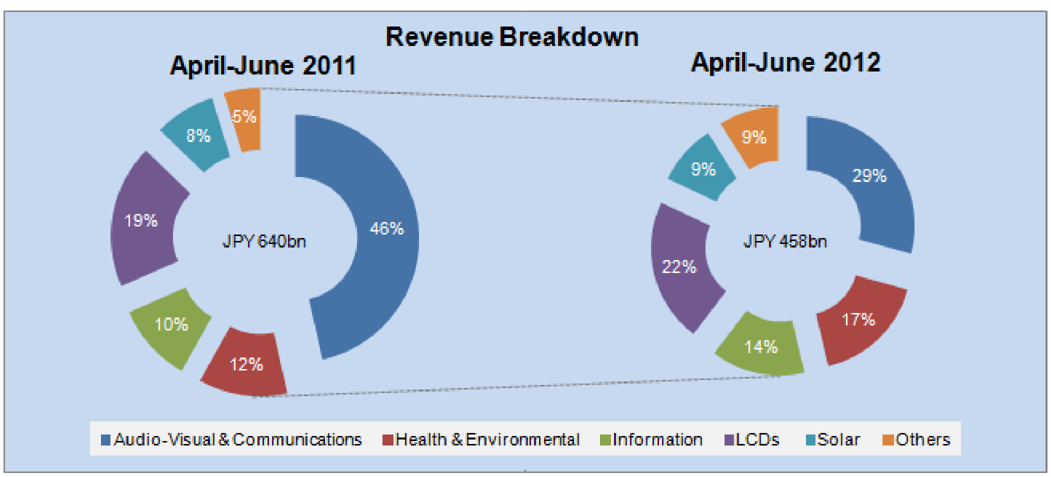
Story of the Week

Deteriorating business prospects and severe liquidity crunch weigh on Sharp's credit outlook

The 1-year RMI probability of default (RMI PD) of Sharp Corporation Ltd ("Sharp"), the Japanese-based electronics and electrical appliance manufacturer, has increased significantly in the two months to August 20. Concerns about the viability of the company's most important product lines, ongoing losses and a severe liquidity crunch have placed upward pressure on the company's RMI PD. Sharp faces declining global demand for its mainstay LCD-related products, amid aggressive global competition. In addition, the company needs to refinance JPY 360bn of outstanding commercial paper. The company held JPY 217.7bn of cash equivalent assets at the end of June 2012; an equity injection from Taiwan-based Hon Hai Precision Industry may ease the current liquidity shortage.



LCD-related businesses accounted for bulk of revenues: During the April to June 2012 period, LCD-related products accounted for about 50% of group revenues. This includes the manufacture and sale of LCD-related products, such as Sharp's own Aquos brand of LCD TVs and LCDs for mobile phones (both included in audio-visual and communications in the graph below), and the manufacture and sale of LCDs of various sizes to third-party manufacturers including Apple (LCDs in the graph below).



Waning global TV demand and aggressive overseas competitors: Global demand for televisions has declined in recent years. The three major Japanese manufacturers, Sony, Panasonic, and Sharp, expect to sell around 10m fewer TVs combined this year than they did in the previous 12 months. Industry competition has also increased, with Korean-based manufacturers Samsung Electronics and LG leading industry sales with a combined market share of 31% in Q1. According to HDTV magazine, Sharp's global share of the LCD TV market, has fallen from 21% in 2005, to 8% in 2011.

The price and volume declines in Sharp's LCD related-product lines have been so rapid that the company has been unable to stem a large decline in earnings. Slowing revenues in the company's audio-visual and communications segment and from sales of LCDs to third parties accounted for 88.8% of the JPY 94.1bn operating loss in the April to June 2012 period, down from a JPY 3.5bn operating profit during the same period in 2011.

A need for a sustainable business strategy and operating structure: Sharp has invested about JPY 340bn in its LCD plant in Sakai City, reputed to be the world's most advanced LCD plant. However, Sharp's strength in LCDs is also its achilles heel, as the Sakai City plant is currently underutilized. Moreover, the company is planning to accelerate LCD inventory reduction. Sharp is likely to remain in the red; management has estimated a JPY 250bn net loss for the current financial year ending March 2013. Planned re-organization and re-structuring initiatives, including down-sizing personnel levels, will likely incur additional costs, and will take some time to gain traction.

The weakened operating environment has taken a toll on Sharp's ability to generate profits to sustain shareholders' capital, and operating cash flows to pay off debts. A net loss of JPY 138.4bn in the three months ended June 30, reduced shareholders' capital, causing the shareholders' equity to total assets ratio to fall to 18.7% on June 30, from 23.9% on March 31. During the same period, the company's net debt to equity ratio increased from 1.36 times to 1.86 times. For the financial year ended March 2012, Sharp recorded an operating cash flow deficit of JPY 143.3bn.

In light of Sharp's weak business outlook, and constrained cash flows, the company is facing a severe liquidity crunch. Sharp has JPY 200bn in unsecured convertible bonds due in September 2013, and JPY 7bn of unsecured Euroyen notes due before April 2013. Of more immediate concern is a need to re-finance an estimated JPY 360bn of outstanding commercial paper. The company held only JPY 217.7bn of cash as of June 30 2012. Ongoing poor financial performance will likely impair the company's access to capital markets and/or contribute to higher borrowing costs.

Will fresh capital from Hon Hai be enough? Reports on August 17 said that Taiwan-based Hon Hai Precision Industries, better known as Foxconn, planned to double its potential stake in Sharp to 20%. However, Hon Hai reportedly only wishes to pay JPY 200 per share, down from JPY 550 per share initially agreed upon in March. This will raise around JPY 49bn in new capital, lower than the JPY 66.9bn Hon Hai proposed in March. A capital increase is needed to meet maturing financial obligations; Sharp is also rumored to be considering large asset sales to meet its commitments.

Sources:
How the mighty have fallen (HDTV magazine)
Options narrowing for Japan's cash-strapped Sharp (Reuters)
Hopes dim for Sharp amid Japan's TV industry sunset (Reuters)
Fitch: Sharp operational difficulties unlikely to recede (Reuters)
Moody's downgrades Sharp to P-3, may cut further (Reuters)
Sharp running out of options (Industry Week)
Sharp jumps on revamp plan reports (Reuters)

In the News
Spanish banks lean heavily on the ECB **Aug 14.** Spanish bank borrowing from the ECB reached a record high during July, increasing 11.3% month-on-month to EUR 375.55bn. Spanish banks now represent 33% of the total liquidity the ECB has provided to eurozone lenders. Spanish banks' other sources of funding have dwindled as northern European banks reduce exposures to the south, and foreign investors become increasingly wary of the sector following the Spanish government's request for EUR 100bn from the EU to bailout struggling Spanish banks. Lenders are looking to reduce their reliance on foreign funding by increasing deposits and cutting exposures to the troubled real estate sector. (WSJ)
European Banks Tackle a Mountain of Bad Debt **Aug 15.** A study by PricewaterhouseCoopers (PWC) estimates European banks sold a record EUR 27bn in non-core loans in the first half of 2012. PWC also estimates European lenders will sell up to EUR 50bn this year, up from EUR 36bn in 2011. However, these numbers are small compared with estimates from most

investment banks, who said that European lenders must reduce assets by over EUR 2tr to reach a state that could be described as adequately capitalized. The de-leveraging process has been slowed by reluctant investors including private equity firms, who are worried about the economic outlook for the Eurozone. (WSJ)

Singapore bonds beat peers in shrinking AAA pool, corporate bond issuance increases

Aug 17. Singaporean government bonds may return 11.2% this year in USD terms according to Bank of America Merrill Lynch data; a rate almost 10 times that of global peers. Safe haven flows have pushed up the price of government securities, as Singapore remains one of only seven nations rated AAA with a stable outlook by the three major global CRAs. Large ongoing budget surpluses have allowed the government to use bond sales to develop domestic capital markets, by creating benchmarks for interest-rate swaps and corporate borrowing. Non-government sales of SGD denominated bonds in 2012 have increased 19% from the same period in 2011. (Bloomberg)

Risks of California muni bankruptcies rising: Moody's

Aug 17. Moody's Investors Service said bankruptcy filings by Californian cities are likely to increase. City budget gaps have widened significantly as sales and property tax revenues remain weak, while the costs of pensions and health benefits for public sector workers increase rapidly. Californian constitutional rules prevent the state from intervening in the financial affairs of stressed city governments, which Moody's believes is a key reason Californian cities may use bankruptcy as a tool to extract bondholder concessions to solve budgetary problems. Three Californian cities have sought bankruptcy protection since June; a Chapter 9 filing by the city of Stockton in June was the largest ever recorded. (Reuters, Moody's)

Correction: In the third line of paragraph 8, '200bn' has been replaced by '200' on August 22.

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