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Transforming Big Data into Smart Data

Weekly Credit Brief

Apr 01 - Apr 07 2014

Story of the week

China mini-stimulus credit positive for railway construction companies

By James Weston

The Chinese government announced on April 3 it would speed up the construction of railway lines and boost funding for railway construction in developing regions, amongst other economic stimuli. The government plans to build over 6,600km of new railway lines in 2014, 1,000km more than in 2013. The move is credit positive for China Railway Group Ltd (CR Group) and China Railway Construction Corp Ltd (CRC), which form a virtual duopoly in China's railway construction industry, as it will support each company's EBIT growth and help offset increasing leverage. RMI probability of default (PD) data reflects the credit positive implications of this announcement, with both companies' 1-year RMI PDs continuing to fall after the announcement. Both CR Group and CRC's RMI PDs have decreased since early 2014, when concerns over high leverage and corruption led to an increase in both companies' RMI PDs. (Figure 1).

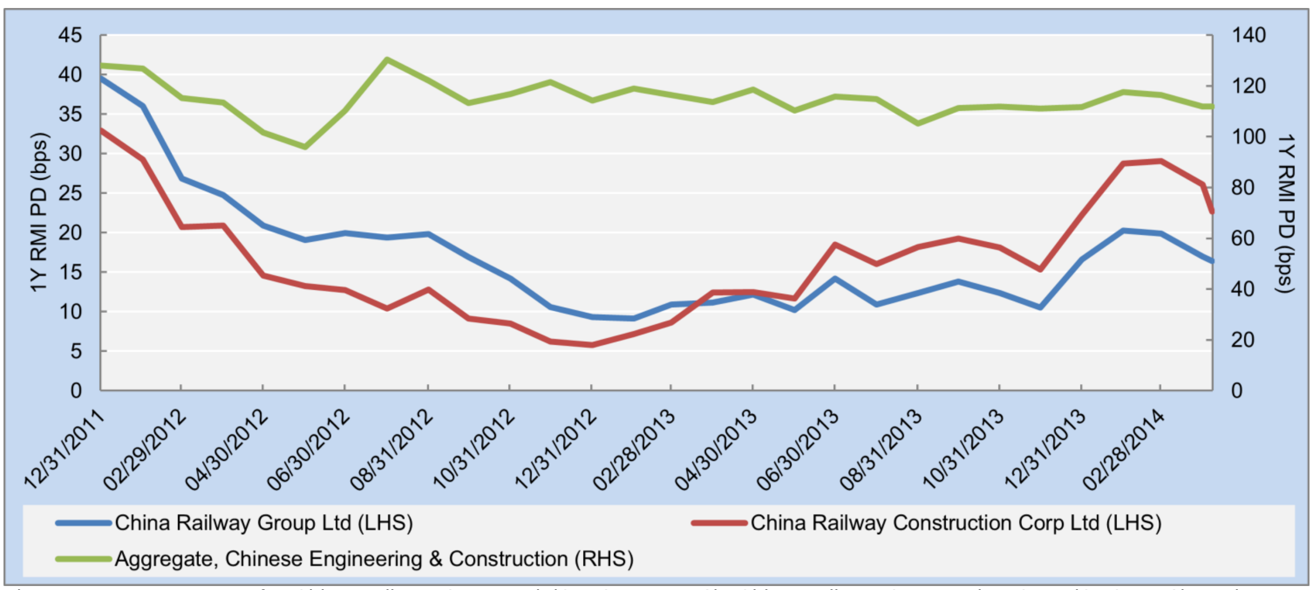

Figure 1: 1-year RMI PD for China Railway Group Ltd (CR Group, LHS), China Railway Construction Corp (CRC, LHS), and 1-year aggregate RMI PD for listed Chinese Engineering & Construction companies (RHS). *Source: Risk Management Institute*

The government also announced it would sell CNY 150bn of bonds to help build railways in the less-developed central and western regions of China, and create a development fund of CNY 200-300bn a year to increase sources of rail financing. The development funds should support both companies EBIT growth going forward, with Chinese Premier Li Keqiang emphasizing the importance of railway investment in the economy, stimulating investment, industry growth and urbanization. In addition, this should help reduce debt levels and financing costs for CR Group and CRC going forward if the development fund directly finances both companies' borrowing needs, and help to reduce both companies' dependence on local debt markets. Both CR Group and CRC have recently seen large increases in leverage as they have increased borrowings to finance working capital needs (Table 1, overpage).

Concerns about growing leverage and corruption within the railway industry were highlighted when CRC said President Bai Zhongren had passed away in an accident on January 4. He was rumored to have been under investigation as part of an ongoing anti-corruption drive by the incumbent Chinese leadership. The incident brings back memories industry-wide problems in 2011, when former railway minister Liu Zhijun and another top official were removed from their offices on corruption charges, and a high-speed crash in Wenzhou that killed 40 people. It also drew attention to CR Group's high leverage and continued problems forcing customers to pay bills on time, with high leverage also evident at primary competitor CRC. CRC's lower RMI distance-to-default (DTD), a volatility adjusted measure of leverage, compared with CR Group leads to a relatively higher RMI PD for CRC.

However, the credit profiles of both companies are underpinned by a high likelihood of state support, given their role as the two leading state-owned enterprises in a strategically important industry. This is reflected in CR Group's and CRC's relatively low RMI PD compared to the aggregate RMI PD for listed Chinese Engineering & Construction companies (Figure 1, previous page), and in the relative size of the two companies (Table 1). The relative size used in the RMI PD model measures the size of a company's market capitalization relative to the median market capitalization within an economy, and is a significant determinant of RMI PDs for Chinese companies. A previous publication has shown this variable may act as a proxy for government ownership in China. Readers should note the primary listing of both CR Group and CRC is in Hong Kong, so the relative size for each company is computed using the median market capitalization of Hong Kong-listed companies.

China Railway Group Ltd		Q4 2013	Q3 2013	Q2 2013	Q1 2013	Q4 2012
EBIT		**4,781**	**4,506**	**3,293**	**3,231**	**5,129**
Financial Expense/(Income)		(29)	944	305	1,081	696
Income Tax Expense		1,424	556	870	586	953
Net Income		**3,387**	**3,007**	**2,118**	**1,564**	**3,480**
Working Capital Needs		104,008	122,858	110,169	98,200	89,147
Net Debt		124,029	143,252	133,347	119,447	109,234
1Y RMI PD (bps)	**(Apr 7: 16.4)**	16.6	13.8	14.2	11.2	9.3
RMI DTD	**(" : 3.22)**	3.18	3.37	3.37	3.79	3.89
Relative size	**(" : 3.72)**	3.74	3.77	3.75	3.79	3.88
Cash / TA (RMI Adjusted)		13.6%	12.7%	13.7%	13.2%	13.4%
Net Debt / 12m trailing EBIT		7.84x	8.87x	8.89x	7.98x	7.78x
12m trailing Interest Coverage ratio		6.87x	5.34x	5.37x	4.29x	4.13x

China Railway Construction Corp Ltd		Q4 2013	Q3 2013	Q2 2013	Q1 2013	Q4 2012
EBIT		**5,340**	**4,078**	**4,434**	**2,959**	**5,625**
Financial Expense/(Income)		1,223	939	696	913	879
Income Tax Expense		762	766	670	401	1,186
Net Income		**3,354**	**2,372**	**3,068**	**1,645**	**3,560**
Working Capital Needs		56,736	58,220	62,689	33,496	14,539
Net Debt		61,076	51,221	58,370	18,357	1,466
1Y RMI PD (bps)	**(Apr 7: 22.7)**	22.2	19.3	18.5	12.5	5.8
RMI DTD	**(" : 2.67)**	2.66	2.68	2.66	3.3	4.22
Relative size	**(" : 3.73)**	3.77	3.83	3.77	3.84	3.98
Cash / TA (RMI Adjusted)		17.5%	17.1%	18.5%	18.5%	22.0%
Net Debt / 12m trailing EBIT		3.63x	3.00x	3.61x	1.22x	0.10x
12m trailing Interest Coverage ratio		4.46x	4.99x	4.62x	4.33x	4.34x

Table 1: Pro-forma financials and risk metrics for China Railway Group Ltd (CR Group) and China Railway Construction Corp Ltd (CRC). Figures are in CNY millions, except for RMI DTD, relative size and where otherwise indicated.
Source: Company financial reports, Risk Management Institute

Credit News

Malaysia interest rate swaps reach two-year high; MYR falls

Apr 03. The rise of Malaysia's one-year interest-rate swaps to its highest level since July 2011 may augur an impending increase in borrowing costs by the central bank over the next 12 months as inflation quickens. Consumer prices may climb further after year on year inflation gains reached a 32-month high of 3.5% in February. The government plans to tighten fiscal measures, including introducing a consumption tax in 2015 and reducing subsidies for items like sugar and cooking oil. Analysts are predicting that the Bank Negara Malaysia will finally raise its benchmark its interest rate of 3% by 50 bps after keeping it unchanged for nearly 3 years. **(**Bloomberg**)**

Brazil raises key interest rate to two-year high

Apr 02. The Central Bank of Brazil raised its benchmark Selic rate by 25bps to 11% on April 2, which is the highest in over two years. A severe drought in south-eastern Brazil has resulted in inflation levels exceeding the central bank's target of between 2.5% and 6.5%. Even though the Selic rate has risen by 375bps since April 2013, the central bank is still struggling to combat inflation. However, analysts do not expect the country's tightening cycle to continue in May, as further rate increases could impede the country's economic growth which has been stagnant for the last three years. The monetary authority will therefore have to find a balance between controlling inflation and avoiding further economic slowdown. (Chicago Tribune)

Borrowing costs in recovering Greece fall to pre-bailout levels

Apr 02. Yields on 10-year Greek bonds fell to a four-year low of 6.31% on April 2, after the Chairman of euro zone finance ministers reported that Greece was fully funded for the next 12 months and the country could return to capital markets for funding. Demand for Greek debt has risen due to increased interest in high-yielding assets to boost investor returns amidst the current low interest rate environment, and growing confidence amongst investors that the country is on a path of gradual recovery from its debt crisis. However, worries remain on potential policy instability, as Greece's ruling party only holds a two-seat majority in parliament. (Reuters)

ECB ready to print money if 'lowflation' lingers too long (Reuters)

India's revised Basel III capital regulation timeline is credit negative for banks (Business Standard News)

Singapore seen sticking with tight monetary policy as economy shows resilience (Reuters)

Regulatory Updates

Basel Committee releases progress report on implementation of Basel regulatory framework

Apr 07. The Basel Committee on Banking Supervision updated the implementation status of Basel regulations across member states. The document briefly gives an overview of how the Basel's capital standards in various jurisdictions are being transformed into national law or regulation according to the internationally agreed timeframe. According to the report, most of the member states with the exception of Japan, Belgium, Mexico, Netherlands, UK, Spain and Russia have applied the Basel III risk based capital rules to their local banks. (Basel Committee)

The Federal Reserve extends deadline for banks to conform to Volcker rule

Apr 07. The Federal Reserve exercised its authority to give banks two more years to divest its holdings in collateralised loan obligations (CLOs). The Volcker Rule, initially designed to ban proprietary trading, would have compelled lenders to offload their CLO investments from their balance sheets. The Fed said that the compliance date has been extended to July 21, 2017 and only CLOs held as of December 31, 2013 would be eligible. Some banks had hoped instead that the Fed would implement a grandfather clause so that CLOs receive the same treatment as the exemption extended to banks holding collateralised debt obligations backed by trust preferred securities. (US Federal Reserve, FT)

Indonesia's bank regulator pushes consolidation of small lenders (Bloomberg)

Banks face capital hit from 'punitive' EU pensions rule (eFinancial News)

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