GE troubled by power unit slowdown and legacy issues at GE Capital

by Liu Hanlei

Since John Flannery took over the helm at General Electric (GE) on Aug 1, 2017, GE's stock price has fallen about 50%. However, GE's problems stem from earlier years when the previous CEO, Jeffrey Immelt, was in charge. The poor performance of GE is mainly attributed to three aspects: the slowdown in its power business - its biggest division which contributed 28% of GE's revenue in Q4 2017, its weakening financial position caused by acquisitions of businesses that did not perform as expected, and the legacy problems with GE Capital.

Revenue from the power division which sells and services equipment to power plants fell by 15% YoY in Q4 2017 and its operating margin fell from 24.4% to 2.8% during the same period. The outlook for the power division in 2018 is also bleak given its expectation to install gas turbines amount to 30gigawatts, the lowest gas turbine installation in 15 years. Part of the reason for this decline in installation could be the growing shift in investments to lower-cost solar and wind power. According to IEA, USD 316bn of investments went into renewable energy worldwide in 2017, three times as much as the USD 117bn that went into fossil fuel power generation. Also with the improvement in battery storage, the need for gas turbines to support the grid during peak demand for power has been reduced. Analysts are predicting that the market for gas turbines is likely to remain difficult and the decline could be an industry structural problem rather than a cyclical one. GE's management is expecting the outlook for power division to be challenging for 2018 with an expected drop in profits for Q1 2018. This is followed by a cut of more than 12,000 jobs as part of an effort to reduce the overall structural costs by USD 3.5bn.

Moreover, GE's financial position is not in a good shape especially with its high debt amid weakening business segments from the industrial division. This is evidenced from GE's industrial group margin falling over the past quarters seen in table 1 below, dragged down by weakness in the power division. GE's EBIT to Interest Expense has also fallen from 5.80x to 2.66x in Q3 2017 and was negative in Q4 2017. Furthermore, GE's Net Debt/Equity ratio is the highest among its industry peers at 73.7% in Q4 2017. As a comparison, Siemens, which specializes in power & gas and healthcare, has its EBIT to interest expense at 7.32x and Net Debt/Equity ratio at 53.4% while United Technologies, GE's competitor in the aviation industry, has its EBIT to interest expense at 8.05x and Net Debt/Equity ratio at 58%.

To add on to its woes, GE spent USD10bn to acquire the energy operation of Alstom and USD 7.4bn to create a merged company with Baker Hughes in 2015. The acquired businesses were expected to improve GE's cash position through cost savings and synergies in operations and revenue. Instead, cash flows from industrial operations have decreased from about USD11.6bn in 2016 to USD 9bn in 2017.

	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4
Net income (USD mn)	3,667	653	1,367	1,836	-9,642
Industrial group margin (%)	18.7	12.6	13.2	11.8	11.2
EBIT to Interest Expense (x)	5.80	2.05	3.01	2.66	-14.45

Table 1: Financial Data for General Electric Co. *Source: Bloomberg*

In addition to GE's challenges in the industrial division, it also announced a USD 11bn charge to Q4 2017 results. This includes a USD 6.8bn insurance charge in its long-term care insurance portfolio at GE Capital which resulted in a plunge in the net income of GE in Q4 2017. GE has reviewed that GE Capital will need to inject USD 15bn into one of its units, North American Life & Health, from 2018 to 2024 for potential payouts. The increase in contribution from GE Capital is due to the growing claims regarding its unit's long-term care insurance contracts and a projected lower future investment yield. The weak performance in the power division and the issue at GE Capital halve management's expectation of earnings per share for 2018 from an earlier projection of USD 2 to USD 1.

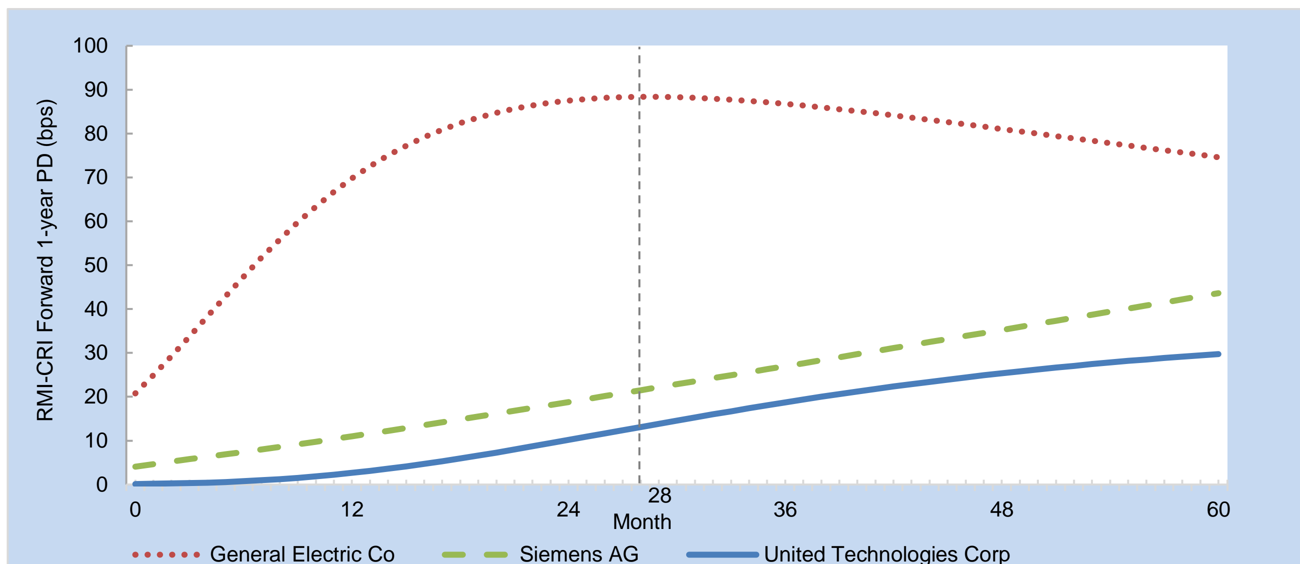

Figure 1: RMI-CRI Forward 1-year PD term structures for General Electric Co, Siemens AG and United Technologies Corp on Apr 13, 2018.
Source: RMI-CRI

In Figure 1, the term structures of the RMI-CRI Forward 1-year Probability of Default (Forward PD) for three companies are shown. The starting point of the curve, month 0, represents the current RMI-CRI 1-year PD. The PD shows that GE's credit profile is worse than the credit profiles of the two displayed competitors. In addition, the shape of term structure shows that, based on the market information on Apr 13, the credit profile for GE could deteriorate faster in the following 28 months. The Forward PD computes the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 1 year plus 6 months, conditional on the firm's survival in the next 6 months.

To boost its financial position, GE plans to sell businesses with total assets worth about USD 20bn in the lighting and locomotive division. To boost its cash flows, quarterly dividend will also be halved to 12 cents a share which will be GE's lowest payout since 2010. It also plans to focus on health care and aviation units which are performing better in terms of margins, and revamping its power and energy business. There have been talks about breaking up GE, for it to follow the path of Siemens which take on a more decentralized structure by separately listing its divisions. However, some analysts are skeptical that breaking up GE would generate more value as it would reduce the company's diversification and damage its financial strength. Nonetheless, GE's problems seemingly cannot be solved easily and a possible restructuring might be a drawn-out painful process.

Credit News

Indonesian loan bonanza seen tapering off heading into elections

Apr 16. Following the shift in borrowers' attention to the upcoming local polls and the presidential race in 2019, the lending boom of 2017 is set to fade. The sovereign rating upgrade by S&P Global Rating for Indonesia out of junk status in 2017 has increased the number of syndicated loans by USD 28.9bn. The country's sovereign bond has also recently attained an upgrade by Moody's on Apr 13, 2018. After a series of sovereign upgrades, there is a resultant momentum in the Indonesian loan market. However, analysts from Maybank suspects that the surge may slow down with borrowers avoiding decisions to make significant M&A and capital expenditure as they wait for the new elected president. (Bloomberg)

China's economy brushes aside Trump to power ahead in 2018

Apr 16. China's economy is expected to have tuned out all the background noise, which includes trade wars, debt mountains and regulatory crackdowns, as it powered ahead in the first quarter of 2018. According to the median estimated of the economists in a Bloomberg News survey, growth maintained a 6.8% pace in the first quarter of 2018, well exceeding a target of about 6.5% this year. The 6.8% expansion would match the pace of growth in the last quarter of 2017. However, headwinds are likely to strengthen in coming months because of campaigns to curb financial risk and pollution. (Bloomberg)

Russia gambles that its debt is too popular to sanction

Apr 15. Konstantin Vyshkovsky, Head of Russian Finance Ministry's debt department, claimed that the Russian bond popularity might ease the likelihood of US sanctions. Following the announcement of US sanctions plan on Russian debts, foreign investors' offloaded long positions on concern that the sanction might leave the assets vulnerable. Although March's volatility on Russian bond was exacerbated by a selloff from foreign investors, the Russian Finance Ministry does not plan to limit international holdings. Before the offload, foreigners owned a record 34% high of Russia's outstanding ruble debt, indicating Russian's sovereign debt significance in the global market. Considering this, the US Treasury Department has recommended not to sanction Russian bonds. (Bloomberg)

S&P warns of risks in leveraged loan market as deals surge

Apr 12. S&P Global has warned investors of mounting risks in the USD 1tn leveraged loan market, citing that weak lending terms would pose a threat. This is due to the credit cycle approaching its peak amid the surge in deal making in recent months. Bank loan funds have attracted more than USD 3bn of money this year which boosted confidence among dealmakers to finance M&As. Together with recent declines in the US stock market, more M&A activities could happen. S&P warned that leverage was approaching or exceeding levels seen before the 2007 financial crisis in the US and Europe, with weakening quality of covenants in recent years. (FT)

Central bank heavyweights head back to euro government debt

Apr 10. European government bonds have grown in popularity because yields have risen this year from record lows on expectations that ECB is ending its quantitative easing program as the economy rebounds. Major global central banks, especially central banks of China and Norway, are ramping up purchases of euro bonds. This is amid concerns of the dollar weakness and the uncertain outlook for Treasuries after the Trump administration said it would welcome a weaker currency as the US embarks on a huge debt-raising drive. Through bond syndications, central banks have bought significant chunks of debt issued by Belgium, France and a state-backed German bank during the last month. (Business Times)

Moody's upgrades Spain's debt rating, citing growth (Business Times)

S&P revises Japan's outlook to positive from stable (Reuters)

Regulatory Updates

MAS to allow modest and gradual rise of Singdollar

Apr 14. Monetary Authority of Singapore (MAS) will return SGD to a gradual appreciation path after two years in constant stance. The move is prompted by a healthy 4.3% economic growth driven by the manufacturing sector which expanded 10.1% in the first quarter of 2018 compared with the same period last year. All components in the manufacturing sector grew in the first quarter, with electronics and precision engineering the biggest contributors. Services, which makes up 67% of the economy, grew by 3.8% in Q1 2018, slightly up from 3.5% in the previous quarter. The gradual increment of SGD against a basket of currencies of Singapore's major trading partners will ease Singapore's inflation as the move will make imported goods cheaper and expand Singaporeans funding capacity in the overseas venture. (Straits Times)

China's central bank to relax commercial banks' deposit rate ceiling: sources

Apr 13. China's central bank will relax the upper limit of commercial banks' deposit rates, facilitating the market liberalization of interest rates. Deposit interest rates are set around 1.5 times the central bank's benchmark rates in general. This interest rate liberalization reforms act as a key step toward allocating capital more efficiently and avoiding the wasteful investment that continues to plague the world's second-biggest economy, according to some economists. As banks in China are now under the pressure of competing for deposits, the tight regulatory environment will help push forward interest rate liberalization. (Reuters)

RBI may loosen NPA norms to let banks breathe easy (Economic Times)

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