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Weekly Credit Brief Aug 06 - Aug 12 2013

Story of the Week

RMI PD for Financial Technologies skyrockets as stock crashes

By Ang Chung Yuh

On August 6, Mumbai-based National Spot Exchange Ltd (NSEL) announced that it had suspended trading in e-series contract (contracts that trade metals on an electronic bookkeeping system), in anticipation of an order from the government to prohibit the trading of these products (the official order was eventually released). The announcement was the second such blow to NESL, the largest commodity spot exchange in India, after previously declaring that they had suspended trading in most forward contracts, merged the delivery and settlement of all pending contracts except for e-Series contracts, and deferred the settlement of these contracts for a period of 15 days. Financial Technologies India Ltd (FTI), which is the owner of NSEL, has seen its market value tumbled almost 70% since July 31, the date of the first announcement. Trading in the shares of FTI in the first three business days of August was greater than the combined volume seen in June and July.

Figure 1 shows the RMI 1-year probability of default (RMI PD) for FTI plotted next to its market capitalization. RMI 1-year PDs are forward-looking views of a firm's likelihood to default on its financial obligations over the next year, based on market and fundamental data. We can observe that the spike in FTI's RMI PD mirrors the plunge in the company's market value. This is not surprising as a lower market cap, everything else equal, reduces a firm's distance to default (DTD, one of the key inputs in RMI's PD model), or volatility adjusted leverage.

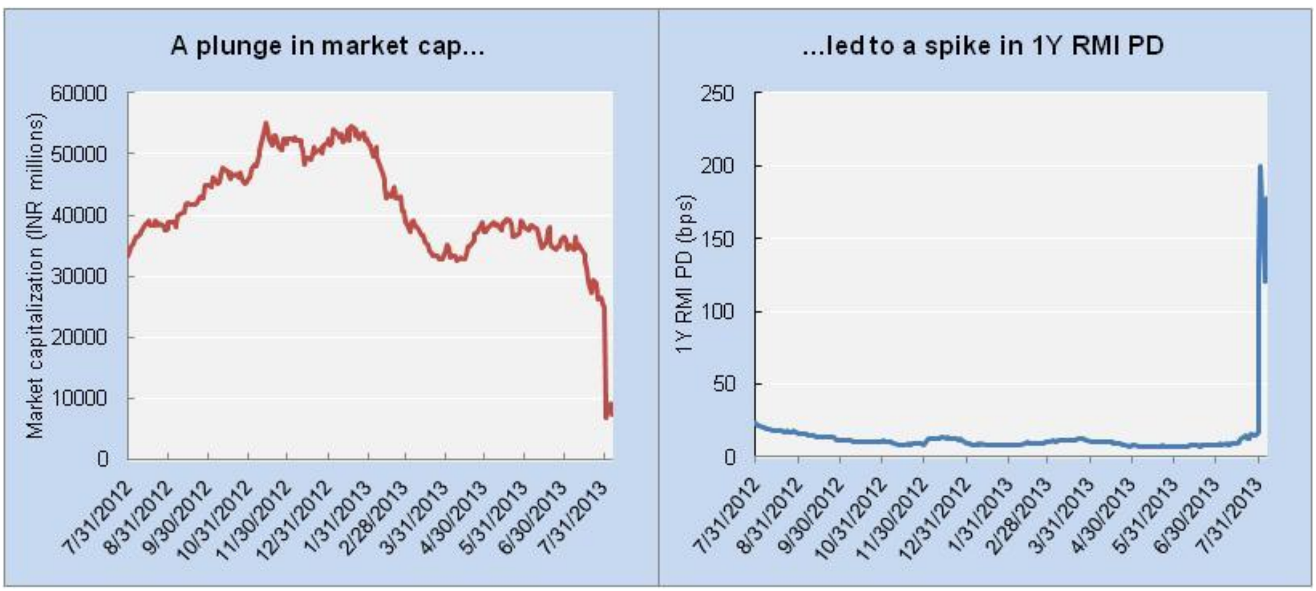

Figure 1: The market capitalization and RMI 1-year probability of default for FTI. Source: *RMI*

Besides negatively affecting FTI's DTD, the nose-dive in the company's market cap also moved at least three other factors in RMI's PD model – the size of FTI's market cap relative to the median market cap of listed Indian firms, its market-to-book asset ratio (which serves to capture the effects of market mis-valuation and/or future growth opportunities) and the idiosyncratic volatility of FTI's stock performance (which measures the stock price movement independent of the S&P Bombay Stock Exchange Sensitive Index).

The share of NSEL's operating results in the consolidated numbers of FTI has increased significantly over the years; the bourse contributed 36% and 55.8% respectively to FTI's revenue and net income in the fiscal year ended March 31, compared to 20.5% and 43% a year ago. Moreover, NSEL's business model was yielding a much more lucrative profit margin than the consolidated entity; the profit-after-tax margin of the exchange over the same period was a whopping 48%, compared to 30.7% posted by the group.

The trading suspensions may leave NSEL without a viable business plan after relying for so long on a model that thrives on regulatory leeway and deriving most of its revenue from one-day commodity contracts that behaved essentially like dated forwards and touted a return of 14% to 15%. This, combined with the recently imposed 0.01% commodity transaction tax on non-agricultural commodities and its negative impact on Multi Commodity Exchange of India Limited, which is 26%-owned by FTI, paint a depressed credit outlook for FTI. The heightened RMI PD for the financial services firm reflects its current situation even though the company's latest financial statement numbers, summarized below together with numbers from past financial statements, do not capture the effects of its current fiasco.

12 months ending	31-Mar-13	31-Mar-12	31-Mar-11
Sales	7402.93	5012.34	4079.07
EBITDA	2020.85	43.86	- 1090.76
EBITDA Margin (%)	27.3	0.88	- 26.74
Net Profit	2274.39	2640.52	- 1368.04
Profit Margin (%)	30.72	52.68	- 33.54
Return on Assets (%)	7.97	13.45	- 8.47
Free Cash Flow	- 80.42	2185.97	- 5086.35
Cash & Near Cash Items	6429.57	5193.80	6621.04
Total Assets	46868.18	37054.16	31854.45
Total Liability	28548.95	19625.46	16154.10
Current Ratio	2.12	3.01	1.9

Table 1: Important financial statistics of FTI from the three most recent fiscal years. (Figures are in millions of INR except for ratios and where indicated) Source: *Bloomberg, RMI*

According to a report from the Business Standard, the risk of the payment crisis spreading to other parts of the Indian economy should be limited, as a little less than one-fifth of the INR 56bn outstanding obligations belongs to the clients of four brokerages – INR 2.5bn each for India Infoline and Motilal Oswal Financial Services (INR 2.5bn), and INR 3bn each for Anand Rathi and Geojit Comtrade.

Figure 2 plots the 1-year RMI PD for two of the brokerages mentioned above (India Infoline and Motilal Oswal), and a steel processor (Metkore Alloys Industries Ltd) which have contracts pending settlement on NSEL. As suggested from the graph, the credit outlook for the three companies were relatively unaffected by the NSEL incident. Metkore Alloys has already offered to pay its outstanding obligations in 5% weekly installments, while the brokerages have asserted that there is no obligation on them to guarantee payment on the forward contracts, which they sold as an arbitrage product to clients.

Meanwhile, Singapore Mercantile Exchange (SMX), which is a wholly owned subsidiary of FTI, has released a statement declaring that it is business as usual at the commodity and currency derivatives exchange. SMX stated that the developments at NSEL "have no impact on its business or any other factors including liquidity and risk bearing abilities."

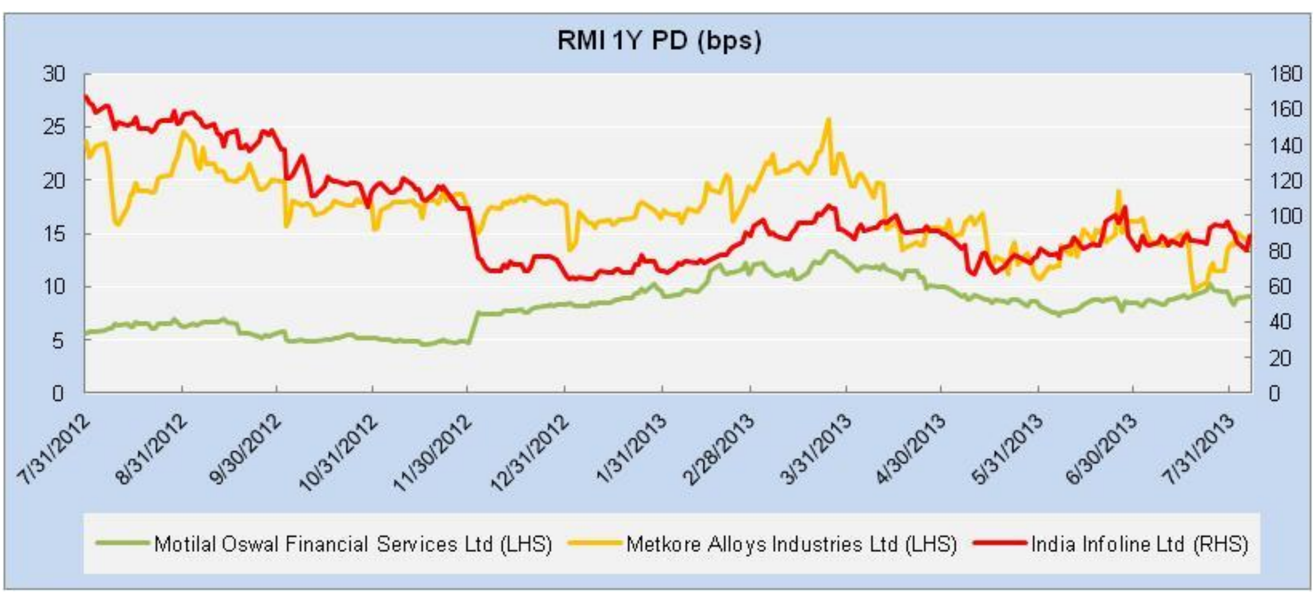

Figure 2: Individual RMI 1-year PDs for 3 Indian companies. RMI PDs relatively unchanged after the payment crisis erupted. Source: *RMI*

In the News

Eurozone banks need to shed EUR 3.2tn in assets to meet Basel III

Aug 11. European banks need to cut EUR 3.2tn in assets by 2018, in order to meet Basel III capital and leverage requirements, according to a recent report by the Royal Bank of Scotland (RBS). Most of this shortfall lies with smaller lenders which will need to reduce assets by EUR 2.6tn, raising concerns over the ability of small-medium sized enterprises to secure funding in future. RBS also singled out Deutsche Bank, Credit Agricole and Barclays as larger banks in need of fresh capital. European banks have already shrunk their balance sheets by EUR 2.9tn since May 2012, with bond issuance tumbling to a decade low. (Financial Times)

Venezuela ogles Chavez's hidden billions as reserves sink

Aug 10. USD-denominated bonds from Venezuela returned 1.63% since July, after the government published rules that require state oil company Petroleos de Venezuela SA and other public institutions to report dollar holdings to the central bank and obtain permission to keep them. The return was more than four times the 0.36% average gain for speculative-grade notes from 37 developing nations tracked by JPMorgan Chase & Co. By returning control over public entities' cash holdings to the country's central bank, Venezuela can more than double its reported reserves and boost its ability to service USD 40.5bn in obligations. (Bloomberg)

Australia sells AUD 700mn of bonds at lowest rate on record

Aug 9. The Australian Office of Financial Management (AOFM), which conducts bond auctions on behalf of the government, sold AUD 700mn of bonds due 2015 at a weighted average yield of 2.4218%, the lowest on record for two year treasury bonds. The auction came four days after the AOFM estimated it would sell AUD 60bn of in the twelve months ended June 30, 2013, the most ever for a fiscal year. Lower borrowing costs will help whoever wins next month's election meet election pledges to return the budget to surplus. Australian bonds have delivered investors the only gains this year among 11 top-rated sovereign markets after the RBA cut interest rates to a record low to help the economy cope with a slowdown of the mining boom. (ninemsn, Bloomberg)

Highest Malaysia sukuk orders signal rebound

Aug 8. Malaysia's sukuk auction on July 19 registered its strongest demand in 17 months, as the MYR 4bn syariah notes on offer was 2.92 times oversubscribed. According to a central bank index, yields on the country's five-year local currency debt fell 5bps to 3.67% after reaching a three-year high of 3.72% on July 31. In comparison, yields on similar-maturity US Treasuries, German bunds and Japanese debt read 1.38%, 0.7% and 0.29% respectively. As such, Malaysian yields remain attractive even as demand for emerging-market assets wane on speculation of reduced US stimulus. (The Star).

Mortgage debt rejected by banks facing new rules

Aug 06. Last month, US regulators approved final rules which substantially revised existing capital regulations for US lenders. Commercial banks have avoided investing in government-backed mortgage securities in response to the new regulations that will result in unrealized losses to be taken into account in bank capital, sending the yields of agency mortgage bonds to a two year high. This translates to higher borrowing costs for consumers seeking to buy homes or refinance. (Bloomberg)

Rising Thai household debt spurs rate tussle as economy slows

Aug 06. Growing household debt coupled with slow growth in Thailand have triggered a struggle between the country's central bank and finance minister on the optimal way to steer the economy out of its slowdown. Although the central bank has raised concerned over a possible credit bubble and has hinted at a possible rate increase, Finance Minister Kittirat Na Ranong believes that the debt rate was "not too high" and wants a cut in interest rate to counter disappointing economic growth. Household debt has risen to nearly 80% of GDP, up from 45% a decade ago. Poor Q1 GDP data prompted the central bank to lower the policy rate by 25 bps to 2.5% in May. (Reuters)

Singapore's economy grew 3.8% in Q2, better full year growth expected (Today)

New crisis lurks in cure for old as Danish probe shows risks (Bloomberg)

Swiss regulator backs bank bail-ins before government rescues (Reuters)

Europe's 'downgrade diary' flags up new market pressures (Reuters)

China money rates slump as central bank moves restore confidence (Reuters)

In wake of cash crunch, PBOC commits to transparency but quietly tightens grip (Reuters)

BofA put toxic debt in bond as staff resisted, US says (Bloomberg)

Carney links rates to jobless to stem interest-rate bets (Bloomberg)

Japan's debt exceeds JPY 1qn as Abe mulls tax rise (Bloomberg)

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