Credit negative on UK automotive sector amid economic slowdown and Brexit uncertainty

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UK reported a GDP YoY growth shrinkage by 0.2% in 2019 Q2, following a 0.5% growth in 2019 Q1. That was the first quarter of contraction since 2012 Q1 and the largest downward contribution was provided by the production industry, especially a sharp decline of 2.3% in manufacturing output in the backdrop of economic slowdown and Brexit uncertainty. The slump coincides with NUS-CRI Aggregate (median) 1 year PD (Agg PD) data. UK auto parts and manufacture companies has experienced the largest PD increase since the UK public voted to leave EU in Jun 2016 compared to other industries, indicating a worsening credit profile and gloomy outlook.

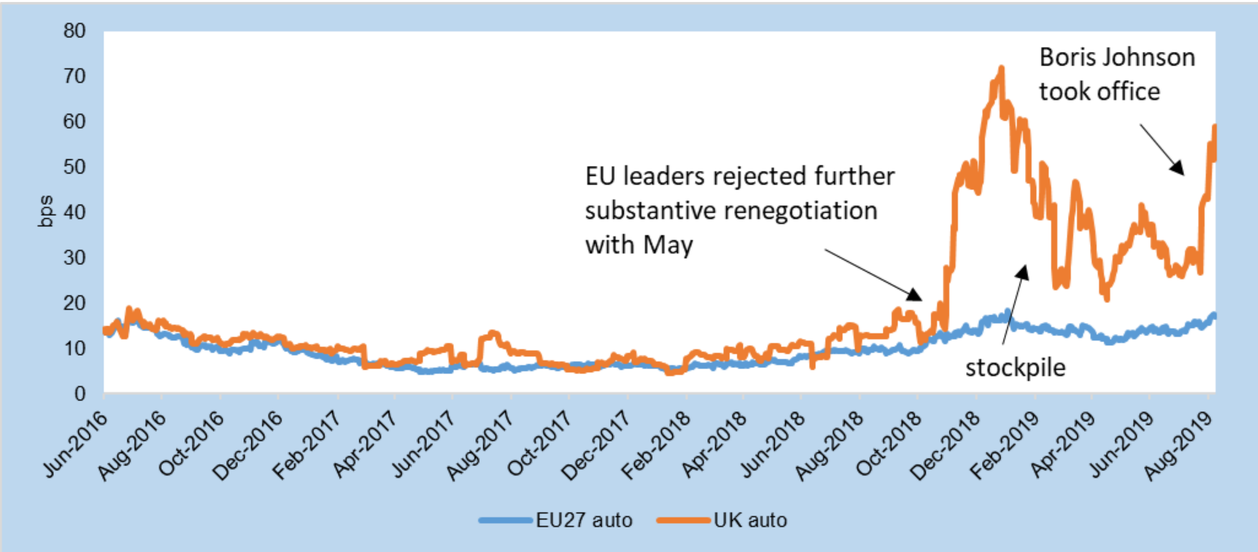


Figure 1. NUS-CRI Aggregate (median) 1-year PD for UK automotive sector and EU27 (exclude UK) automotive sector. *Source: NUS-CRI*

Amounted to a total of GBP 30bn in 2018, UK automotive sector is the largest exporter of goods and has been hit the strongest by a hard or even no deal Brexit. UK industrial confidence index surveyed by European Commission has been dropping since Dec 2018 and fell into negative territory in Mar 2019 when Brexit was originally due to leave EU. The index reached -16.20 in Jul 2019, the lowest in the recent three years. NUS-CRI Agg PD for UK automotive manufacturers stayed constantly same as that for EU automotive manufacturers before Oct 2018 and then surged sharply from 11bps to 70bps in Dec 2018 when EU leaders rejected further substantive renegotiation with May. Agg PD for UK auto firms went down entering 2019. The temporary boost was because customers stockpiled manufactured goods and was expected to prompt future sales fall. Agg PD increased steeply in July 2019 when Boris Johnson took office.

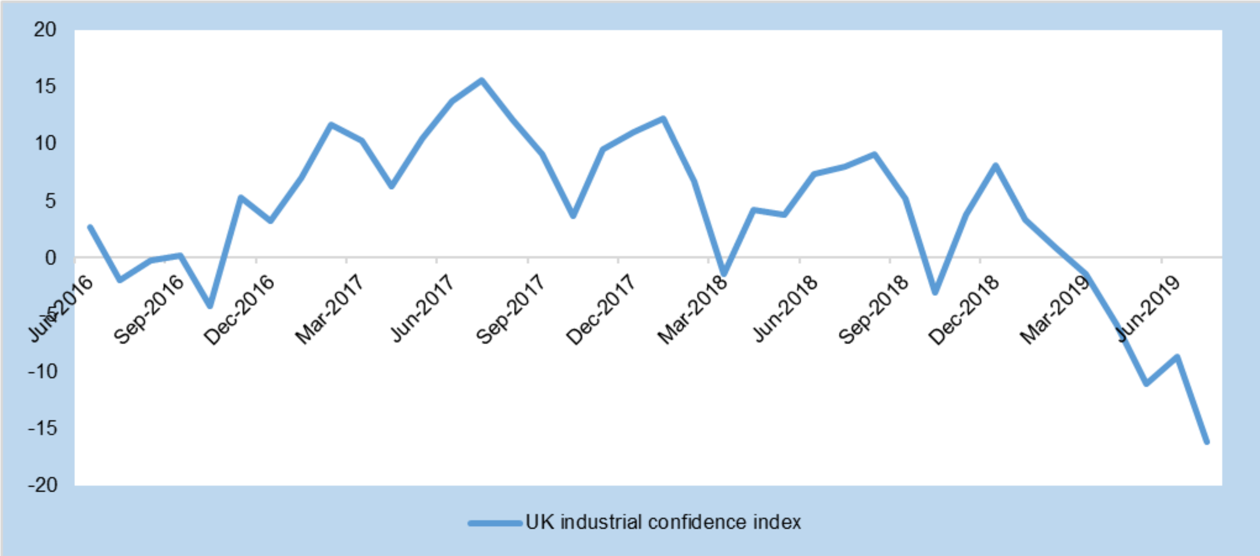
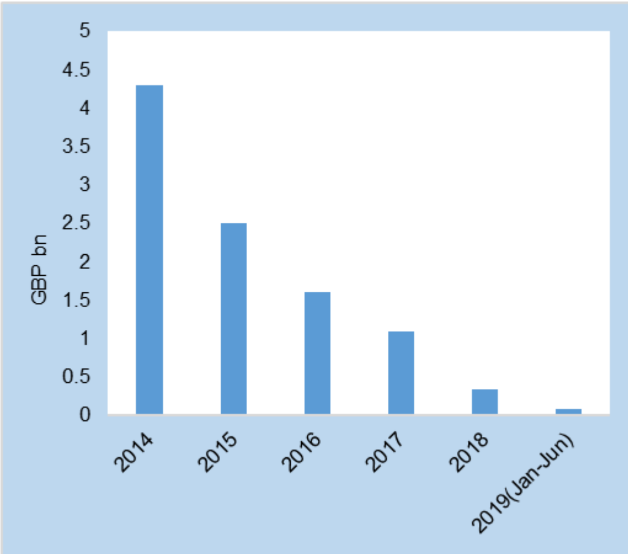


Figure 2. UK industrial confidence index. *Source: European Commission*



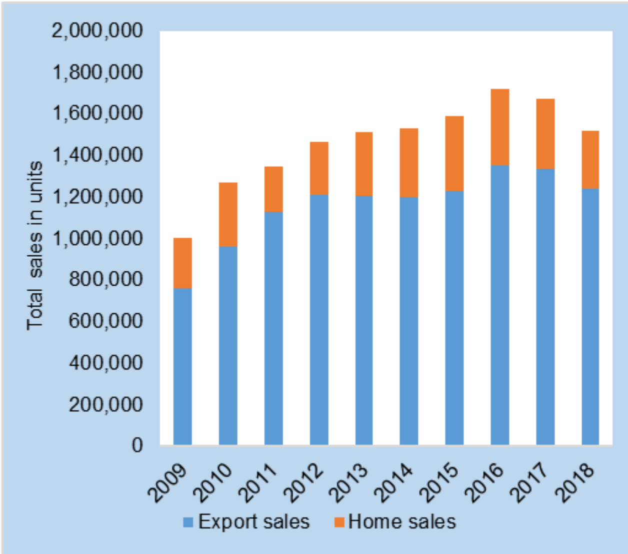


Figure 3a&3b: Investments announced in the UK car industry; Home and export sales of passenger cars manufactured in UK. *Source: BBC, Statista*

Investment announced in the UK automotive industry plummeted at a faster pace to merely GBP 90mn in 1H2019 from GBP 347mn in 2018 and GBP 1.1bn in 2017, according to Society for Motor Manufacturers and Traders (SMMT). However, the companies have been spending heavily on preparations for Britain's exit. UK car firms have relied on export for a long time, with around 80% of cars sold were exported to other countries. Meanwhile, thanks to the tariff free access to EU based supply chain, only 41% of the content of UK built cars is sourced from the UK, with between an additional 20% and 50% sourced from elsewhere in the EU.

UK auto firms SMMT warned some UK's largest automotive manufacturers have already spent GBP 330mn preparing from new IT systems to cope with export checks to renting warehouses to stockpile parts. The spending on preparation squeezed the investment on R&D which they need to survive the reshaping phase of the global industry, but much of the money had been wasted at the same time because the preparation was started from 2H 2018 and most of the change were made for the planned leave date of the end of March this year, which was pushed back. Large carmakers such as Jaguar Land Rover, Vauxhall, and BMW's four UK sites including Mini and Rolls-Royce moved summer holiday to April as well, with a planned costly downtime when Brexit left EU. Since the divorce was delayed, the shutdown was not useful as expected and the knock off cannot be arranged again when Brexit really takes place.

Apart from the declining investment and surging cost from preparing Brexit, automotive firms are also facing a global economic slowdown. UK manufacturing PMI fell below 50 in July, the first time of contraction since 2017. UK car production declines for the 13th month in June 2019 with a fall of 20% compared with same time last year, a similar trend also seen in other major export markets such as China.

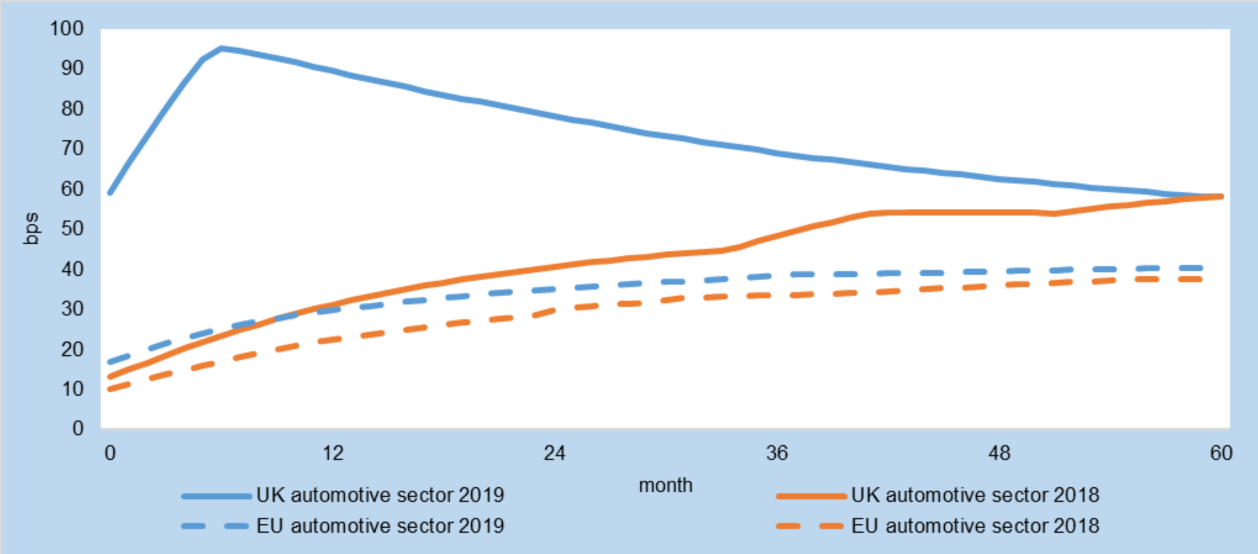


Figure 4. Forward 1-year PD term structure for UK automotive sector and EU automotive sector based on information on 8 Aug, 2018 and 8 Aug, 2019.

Bank of England has forecast a one-in-three chance of economy shrinkage at the start of next year because of Brexit uncertainty and global trade tensions. In addition, with the new Prime Minister Boris Johnson's take-over, the risk of a no deal Brexit has gone up. Boris has promised that October 31 is a key deadline, even if no deal is reached. If EU and UK eventually fail to make a deal two months later, the end of frictionless trade and adding tariff will further pressure the manufacturers. CEO of the PSA Group has threatened to move production plants of a model from the UK to Europe if a no-deal Brexit made production unprofitable. Porsche has also told customers that vehicles ordered before Brexit but delivered afterward could end up being 10% more expensive. As shown in Figure 4, the Forward 1-year PD term structure for UK automotive sector is well above the term structure for EU automotive sector based on the information on 8 Aug 2019, signalling a worse credit profile of UK automotive manufacturers. Seeing a higher increase in PD from Aug 2018 to Aug 2019, the Brexit impact pronounced more in the credit outlook of UK car firms than their peers in EU because UK auto sector is more export oriented. The Forward PD term structure (Figure 4) shows that the UK firms are vulnerable to the increasing Brexit uncertainty especially in the next seven months, with the Forward 1-year PD quickly increasing to the highest point, nearly 100 bps. If a typical UK automotive firm manage to survive till Mar 2020, the credit outlook will turn better with Forward PD gradually decreasing afterwards.

Other NUS-CRI WCBs on Brexit:

Credit outlook for UK firms is worsening relative to its EU peers amid Brexit uncertainty

'No deal' Brexit to hit UK automotive industry

UK export oriented sectors to EU see increased credit risk due to uncertainty of Brexit deal

Credit News

Junk bonds are getting hammered by Trump's trade wars

Aug 9. In the wake of recent escalating trade war, junk bonds fell by more than 1% from July 29, 2019 through August 7, 2019 even as investment-grade company bonds rallied, according to Bloomberg Barclays index data for price and interest returns. Since then, junk bonds have recovered about 0.4%. The safest high-yield bonds reached their weakest level relative to high-grade corporate securities since 2016 by one measure: a fear gauge for speculative-grade market soared the most on August 5, 2019 since March. Investors fear that trade tensions could push some US companies out of business entirely, as UBS strategists forecasted that by mid-2020, 3.2% borrowers (excluding the energy sector) will have defaulted over the prior 12 months, compared with 2.5% now. (Bloomberg)

Short sellers target bonds to profit from UK retail crisis

Aug 9. Investment banks and hedge funds are betting on the downfall of UK shopping centres, building short positions against the equity and bonds of Intu Properties – one of the country's largest retail landlords – as it battles with falling rents and a heavy debt burden. Bricks-and-mortar retailing in the UK is in crisis because of higher costs and consumers going online, trends that have forced a series of big retailers to enter insolvency arrangements and shut stores. Short interest in Intu's largest GBP 485mn bond has more than quadrupled in one month while that in free-floating shares remain at about a quarter of the company's value. Intu revealed a loss of GBP 830mn in the six month to June, nearly double the loss it made during the same period last year. If Intu's properties drop 15% in value, the group would have to stump up GBP 83mn to pay the covenant shortfall to lenders. (FT)

Shady Japan bond sale practice returning as yields fall

Aug 8. Underwriters failed to fully sell at least 22% of the total company-note issues in July, a figure that has more than tripled from the low of 6% in May. As yields fall, investors become pickier, giving rise to shady lending practice in Japan's corporate bond maket that allows bankers to report successful debt sales when they were not. Unsold notes rebounded as an expansion of monetary stimulus globally sparks a jump in Japanese bond sales, making it harder for underwriters to ensure sufficient demand for each deal. Yet investors and issuer companies are often left in the dark about the unsold bonds. To avoid bonds going unsold without their knowledge, more issuers are selling notes using the pot system, under which syndicate banks share details with issuers about bond buyers to find the best-prices. (Bloomberg)

Investors fleeing negative yields fuel private debt cash-pile

Aug 8. Private debt fund managers say the ultra-low interest rate environment is set to drive more money into the business of lending to mid-sized companies. In a world brimming with negative-yielding debt, European direct lending funds typically offer a return in the high single digits and some managers add leverage to boost yield even more. Investors are likely to demand more higher yielding private credit assets with strong downside protection in an ultra-low rate environment. Investors building up their exposure to private corporate loans include pension funds and newcomers who have so far put little or no money into the asset class. Institutional investors' appetite is also driving fund sizes higher. (Bloomberg)

China builders weaken debt safeguards as buyers chase yield

Aug 7. The trend of Chinese property developers borrowing money from bondholders on looser terms shows no sign of going away: the average covenant quality score for property firms fell to the weakest last quarter since Moody's began compiling the figures in 2011. A blistering 10% return on Asian junk bonds in the first half of 2019, of which Chinese real-estate firms account for a majority, saw investors profiting greatly, further driving new deals underpinned by record order book sizes. This is storing up risks on Chinese developer notes which may be getting closer to materializing due to the rising yuan volatility and curbs on financing. Moody's notes several concerns: growing credit facility carve-outs (that allow borrowers to load up on extra debt); falling fixed charge coverage rations (that makes it easier for issuers to borrow more). Covenants in bond agreements are supposedly used to protect bondholders against failures, but those terms are getting more borrower-friendly. China's real-estate sector topped the year-to-date onshore default list in July and the recent slump in yuan further adds pressure on the dollar-denominated debt market. (Bloomberg)

Investors dump risky assets as trade war flares (FT)

Junk bond spreads widen by most in three years (FT)

Trade war fear deepens US yield curve inversion (FT)

Regulatory Updates

RBI moves unlikely to ease pain for India's struggling shadow banks

Aug 7. India's central bank are proposing two measures which are targeted at easing liquidity pressures on crisis-hit shadown banks but are seen as unlikely to lead to any substantive improvements in the troubled sector. The Reserve Bank of India(RBI) would allow banks to increase their exposure to a single non-banking finance company(NBFC) as it aims to boost credit to cash-strapped NBFCs, or shadow banks. The RBI has also allowed banks to classify loans to NBFCs for key areas such as agriculture, housing and small and medium businesses as priority sector lending, to keep credit flowing to parts of the economy where most Indians work. NBFCs have been facing credit concerns since IL&FS collapsed in late 2018 amid fraud allegations. The fall of IL&FS pushed up borrowing costs for rivals which has sharply impacted consumer spending and stung sectors such as real estate and autos which are big drivers of consumer demand. Although the measures are aimed to ease liquidity for NBFCs, the regulator is also keen to ensure the stability of systemically important NBFCs. (Reuters)

Banks tighten standards on commercial real estate, credit card loans

Aug 6. US Banks left loan standards unchanged on commercial and industrial loans to large and mid-sized firms during the second quarter, even as they eased standards on such loans to smaller firms and eased most terms for all size firms. The US Federal Reserve's quarterly survey of senior loan officers showed that lending standards on commercial and industrial loans are generally easier than has been typical in the period from 2005 until the present. This is a notable finding as a rise in US business debt has raised red flags at the US central bank over financial stability vulnerabilities. Meanwhile standards for commercial and real estate lending, as well as subprime credit card and auto loans, are tighter than has been the norm from 2005 to present. For households, banks tightened standards on credit card loans in the second quarter while they left standards for auto loans and most categories "basically unchanged" during the period. (Reuters)

India court upholds homebuyers' rights in builder bankruptcies (Bloomberg)

ECB to test five Croatian banks as country aims for euro entry (Reuters)