Weekly Credit Brief
Aug 25 - Aug 31 2020

Credit outlook of US automotive firms is negative in spite of recent improvements

by NUS-CRI Market Monitoring Team

In our February Weekly Credit Brief issue, we discussed the deteriorating credit quality in the Chinese automotive industry which was caused by the slowdown in sales and the shutdown of production as China battled the novel coronavirus. This brief aims to re-examine the credit profile and outlook of the automotive industry in the context of the United States. For awhile now, the US automotive industry has been highly leveraged with its Debt/EBITDA standing at 3.8X during the end of 2019. Hence, it is unsurprising to see the weakening of the credit quality within the US automotive sector as showcased by the NUS-CRI Aggregate 1-year Probability of Default below (Agg PD). While the stimulus provided by the US government and Fed managed to calm the markets and reduce the credit risk for US automotive firms, credit outlook remains negative. The NUS-CRI Aggregate Forward 1-year Probability of Default (Forward PD[1]) in Figure 1b indicates that the credit profile for US automotive firms will continue to deteriorate for the next 2-3 years. Factors, such as the uncertainties in future demands and the rising leverage, might have contributed to this seemingly pale outlook.

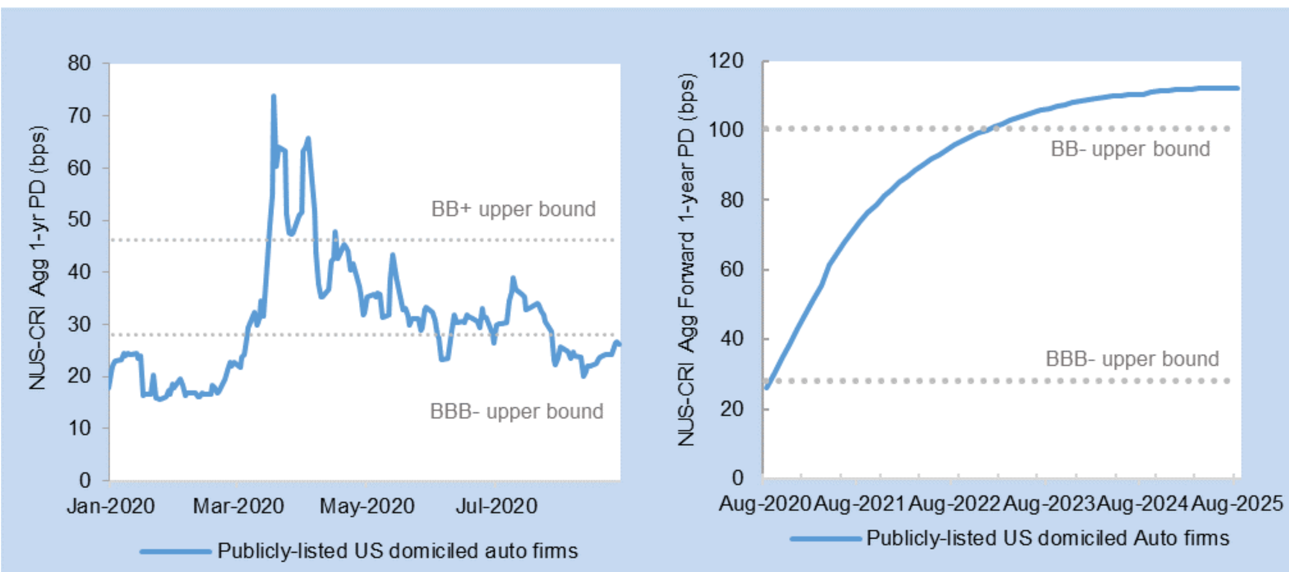

Figure 1a (LHS): NUS-CRI Aggregate 1-year PD of US domiciled automotive industry from Jan 2020 to Aug 2020 with reference to PDIR2.0[2] bounds. Figure 1b (RHS): NUS-CRI Aggregate Forward 1-year PD of US domiciled automotive industry based on data feed from Aug 2020 with reference to PDIR2.0 bounds. *Source: NUS-CRI*

After the outbreak of the Covid-19 pandemic, automotive firms domiciled in the US have been raising debt considerably with the aim of improving their cash positions and therefore shoring-up their liquidity and financial flexibility. For instance, GM and Ford had pre-agreed revolving credit lines, allowing them to easily draw down a collective total of USD 31.4bn. It left them with sufficient liquidity to make it till the end of the year without revenue, if necessary. The low interest rate environment and the Fed's corporate debt buying plan have also allowed companies to issue debt and establish new credit lines. So far, the publicly-listed US domiciled

[1] The Forward PD estimates 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.

[2] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

automotive firms have raised over USD 60bn of debt this year. This, coupled with better cost cutting and efficiency measures, has helped avoid the significant spike in credit risk that was seen among large-cap[3] automakers post the 2008 crisis (See Figure 2). Meanwhile, small-cap US automotive firms, which faced more difficulties in raising debt in the markets, continue to rely on existing revolving credit facilities and government programmes during the pandemic. However, these may not always be enough as some firms are not eligible for some of the government programmes. This could potentially result in financial distresses as they try to survive the demand slump.

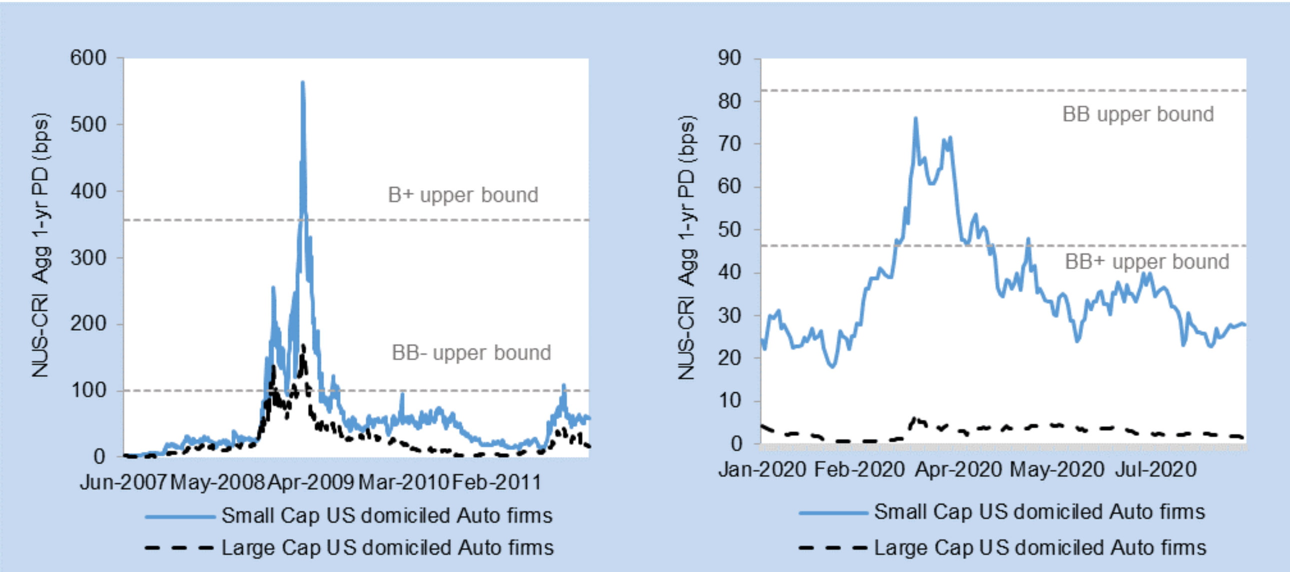

Figure 2: NUS-CRI Aggregate 1-year PD of US domiciled automotive industry divided by market cap size during the 2008 crisis and the COVID-19 pandemic with reference to PDiR2.0 bounds. *Source: NUS-CRI*

All of these measures, however, did not come without any costs. The industry, which was already highly leveraged before the pandemic, became even more leveraged with its Debt/T12M EBITDA increasing to 4.3X as of Jun 30, 2020 data. The industry will have to hope that there will be sustained demand for the following years to meet additional interest repayments on the newly acquired debt to prevent defaults.

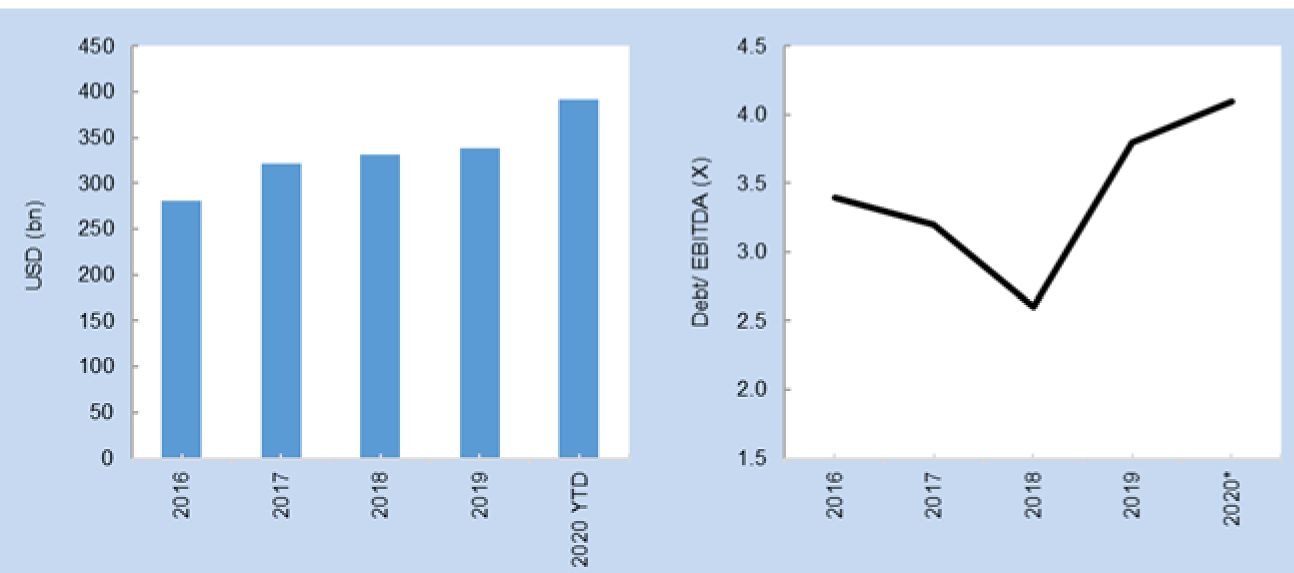

Figure 3a (LHS): Publicly-listed US domiciled auto industry's total debt. Figure 3b (RHS): Publicly-listed US domiciled auto industry's Debt/ EBITDA (*Debt/T12M EBITDA dated on Jun 30,2020 being used for the year 2020). *Source: Bloomberg*

[3] Large-cap firms are defined as those with market capitalization above USD 10bn while small-cap are those with below USD 10bn.

In terms of sales, so far the impact of the pandemic on the US automotive industry has been severe. By Q2 2020, sales have declined by almost 33.3%. Given that the US is the one of the worst-hit countries, with the highest number of Covid-19 infections and deaths, this is not surprising. Since the outbreak in Mar 2020, the industry has faced sustained pressure on both the demand and supply sides. Recently, there has been a demand recovery due to the pent up demand as the US states emerged from the lockdowns. Sales, from the slump in April, have recovered by 37.5% in May, with July sales figures recorded at only 13% below pre-pandemic levels. However, future recovery in demand for automotive products remains uncertain and this further clouds the outlook for the US automotive industry. Analysts predict that US vehicle sales are estimated to be between 10-15% lower in 2021 compared to 2019 levels and full recovery can only be achieved at the latter part of 2022. This recovery forecast might hold with the looming expectations of a second outbreak and a 'double-dip' recession.

The weak and uncertain demand coupled with the increase in industry-wide leverage puts significant pressure on the credit quality of the US domiciled automotive industry. With the sustainability of revenue streams over the next few years being dependent on the state of the economy, expected demand and financial market conditions could possibly be a lot weaker than what is currently assumed. This could negatively affect the firms' profitability, free cash flow and access to financing thereby putting stress on debt servicing. Furthermore, this case scenario has yet to take into account the industry's pre-existing challenges of transition to Electric and Autonomous vehicles which would require a significant investment in R&D. It is, therefore, not surprising that the credit outlook is worsening in the next few years as indicated by the Forward PD.

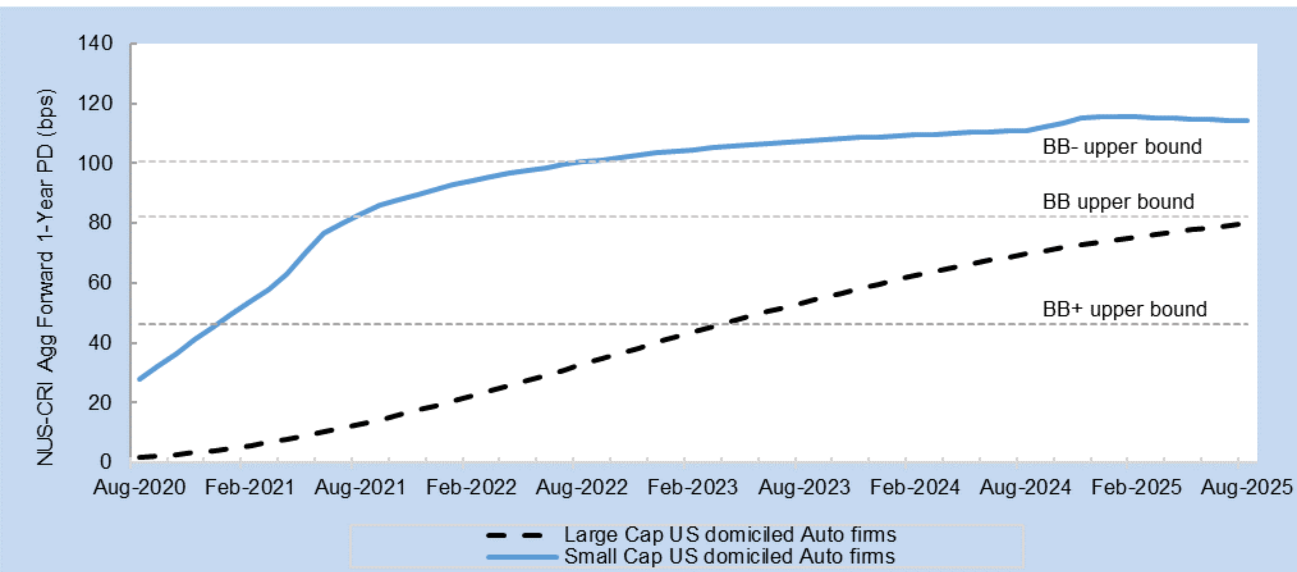

Figure 4: NUS-CRI Agg Forward 1-year PD term structure for US domiciled automotive industry based on data feed as of Aug 2020 divided by market cap size with reference to the PDIR2.0 bounds. *Source: NUS-CRI*

Credit News

Bad debt wave drags China's big banks to their worst profit drop

Aug 31. Due to the Covid-19 pandemic, China has seen their worst economic downturn in 40 years. Banks are pushed to the front the recovery process by extending low cost of financing to struggling businesses. The liquidity availed came at the cost of rising bad debt. Inevitably, this weighted upon the profitability of the banks. It was reported that up to USD 218bn in profit was forsaken. In spite of this, banks are still pressured by the government to continue to support the economy by availing affordable lending and flexible payment structure. In response, the banks warned that the second half of 2020 would continue to be difficult as they increase their loan loss provisions. (Bloomberg)

Expected surge of CLO downgrades slow to arrive

Aug 28. The virus outbreak forced shut multiple businesses in the first half of 2020. As uncertainty continues to prevail for the second half of the year, the credit rating agencies have placed up to 2,400 bonds attached to CLOs for review. The results of the credit reviews were testimonies to how far things have improved from the 2008 Financial Crisis. Since Mar 2020, the number of downgrades has decreased significantly and the pricings for corporate loans have recovered. These avail managers with the flexibility to reposition their books for a healthier portfolio. However, caution should not be thrown into the wind as CLO issuance is still down. In addition, there remain doubts on the credit rating agencies as credible checkers of market risk. (WSJ)

Distressed funds eye European companies as virus support schemes rise

Aug 28. As the governments in the EU is geared to release a widespread series of economic support, funds are prepared to reallocate funding over to the region as they foresee a pick-up in corporate restructuring. Since the virus took hold, managers are expecting a rising number of high profile high yield and leverage loan deals to come their way. The sectors would include travel, aviation, retail, oil and gas companies. In anticipation of the prospects of these rising future deals, the distressed institutional investors have been holding more cash than ever. (Reuters)

Australian banks use bloated cash balances to reduce debt

Aug 26. The Australian banks are flushed with cash. The extensive range of fiscal and monetary policies have availed a fair amount of capital, subsidies and deposits for the local banks. This in turn has allowed the banks to fund less debt heavy loans and drive lower cost of financing. Today, the growth rate of deposits is three-fold of the increment of loans. With the excess liquidity and low funding rate, the cash bloated sheets are net negative with little to no profit for the sector. (Reuters)

Global companies raise most funds for the month of August in a decade

Aug 25. Through Initial Public Offerings and high-yield bond issuances, companies have attained USD 65.5bn worth of funding for Aug 2020. This number is the highest Refiniv has seen for the month of August in the past 10 years. This was bolstered by the generous liquidity of over USD 15tn availed by the central banks all over the world to mitigate the impact of the Covid-19 induced economic fallout. Sectors that benefited greatly from this were the technology and healthcare firms while laggards like travel services, hotels, and brick and mortar retailers fell behind. Moving forward, one could expect increasing merger and acquisition activities as these laggards aim to raise more capital to tide through the second half of 2020. (Reuters)

Brazil debt markets liquid, but little demand for long-dated paper (Reuters)

Uptake of South Africa's COVID loan scheme likely to stay minimal (Reuters)

J.Crew expects to emerge from bankruptcy early next month (Reuters)

Regulatory Updates

In landmark shift, Fed rewrites approach to inflation, labor market

Aug 27. The Federal Reserve has placed a new emphasis on the US labour market. This shift gives employment a greater weight relative to its concerns for stable pricing. With Powell's newly asserted approach to reform the labour market, the FED has expanded to look into income distribution as research has found that the economy would benefit from more inclusive policies beyond targeting unemployment rates. Increasing FED's tolerance for inflation, one could expect the new series of transformation to be founded from a more outcome-based approach, which will be revealed somewhere, down the line. (Reuters)

China to keep 'normal' monetary policy: PBOC official

Aug 26. The head of the monetary policy department at the People's Bank of China, Sun Guofeng, maintained a position that China will not pursue zero or negative rates and other unconventional policies like quantitative easing. Prioritizing certainty in policymaking, liquidity remained ample for the economy as authorities encouraged banks to avail cheaper cost of funding to struggling businesses. Confidence in the banking industry is founded as the capital adequacy ratio of the sector remains well above the regulatory standard of 10.5%. (Business Times)

Lebanon central bank urges bank to recapitalize, repatriate funds (Reuters)

US housing regulator postpones new mortgage refinancing fee (Reuters)

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