Weekly Credit Brief

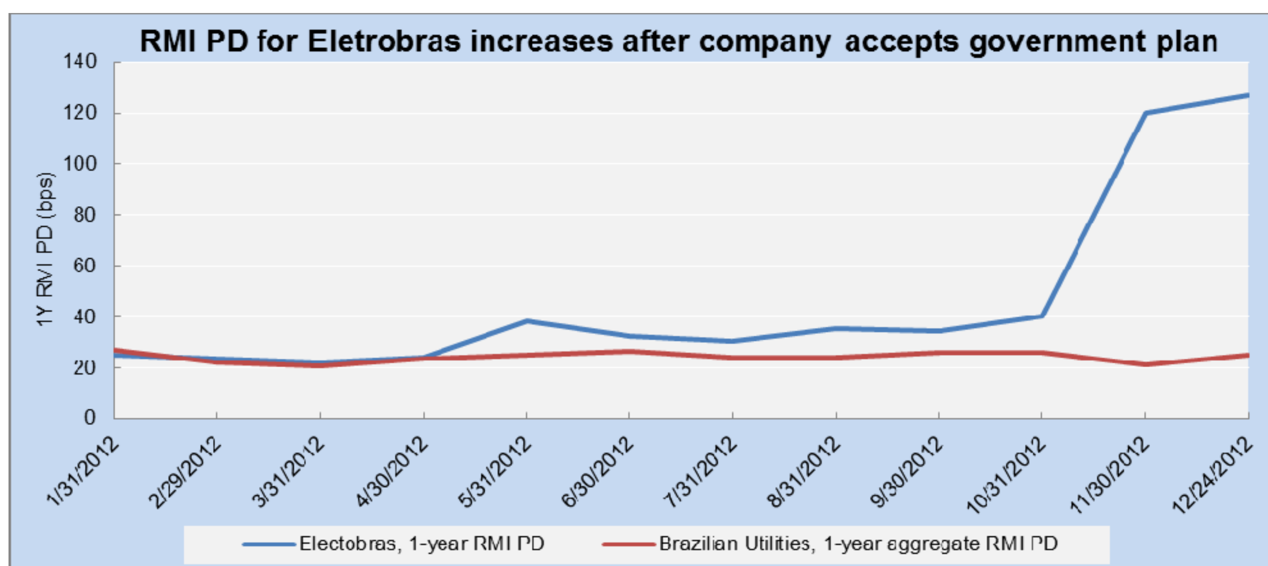
Dec 18 - Dec 24 2012

Story of the Week

Brazilian government plan to lower energy tariffs a credit negative for Eletrobras

By James Weston

The 1-year RMI probability of default (RMI PD) for Brazilian power company Centrais Eletricas Brasileiras SA (Eletrobras), the largest power utility company in South America, increased to the highest level in almost 10 years on December 24. The government last week approved a plan that will see Eletrobras receive BRL 14bn of compensation in exchange for the early renewal of energy concessions expiring between 2015 and 2017, at much lower rates starting in 2013. The plan is aimed at stimulating the Brazilian economy, by lowering productivity costs which should place downwards pressure on inflation rates. The government is seeking a 20% reduction in average energy bills next year.



Eletrobras, in which the Brazilian government holds a majority ownership, accepted this license renewal on December 3. The lower tariffs under the agreement will likely place downwards pressure on the company's revenues going forward. The RMI PD for Eletrobras first spiked in November when the government published details of the compensation plan, due to concerns the government would use its majority voting share in Eletrobras to approve the measures. Other utilities controlled by Brazilian states rather than the federal government, and those under private ownership, have rejected the government's offer to renew generation concessions at lower rates.

This marked increase in the RMI PD for Eletrobras occurred almost a month before two of the three major CRAs took rating actions on the company. Moody's downgraded Eletrobras one notch to Baa3 from Baa2 on December 19, while Fitch downgraded the company three notches to BB from BBB on December 7. The yield spread between 10-year Eletrobras bonds and similar-maturity Brazilian government securities increased to 3% on December 10, up from levels around 2% during the middle of 2012. The spread between the two bonds has fallen slightly since then, to 2.9% on December 21.

The lower tariffs under the compensation plan will reduce annual revenues by around BRL 8bn going forward. The one-off cash compensation payment of around BRL 14bn should help the company meet operational cash requirements through 2013, but earnings will likely remain weak from 2014 onwards, and government support may be required. The company has indicated that the cash compensation will not be used to adjust the company's capital structure through redemption of outstanding debt.

As of December 24, the company had BRL 6.34bn of senior unsecured bonds, BRL 3.28 of secured loans, BRL 13.4bn of unsecured loans and BRL 26.4bn of non-disclosed debt outstanding. The company's total debt to 12-month EBITDA ratio was 6.7 as of September 30, while the company's simple leverage was 2.14. The company's total debt to 12-month EBITDA ratio will likely increase from the current relatively high level, given the reduction in earnings under the new energy concessions. Eletrobras has no disclosed debt maturing until late-2015, when a USD 450mn term loan matures in August and a USD 300mn bond matures in November.

However, the acceptance of the government's compensation plan, which many believe considerably undervalues the company's assets, highlights the political risk associated with Eletrobras. The government used its majority shareholding to approve the compensation measures in exchange for lower tariffs, a sign the government is willing to use majority state owned companies to pursue political and economic goals, at the expense of bondholders and other investors. The largest minority shareholders dissented.

Sources:
Eletrobras in record slump as rate cuts imperil earnings (Bloomberg)
Eletrobras accepts steep rate cuts for renewed licenses (Reuters)

In the News

Bank of America delinquent loans mean losses

Dec 19. Bank of America's USD 64bn backlog of delinquent mortgages will take years to work through as borrowers fall behind their mortgage payments and investors write down losses on their investments in mortgage backed securities. The amount of loans that are at least 6 months delinquent and yet to enter foreclosure is more than twice the combined figure of its four largest competitors. However, the bank highlighted that 930,000 loans which are at least 60 days delinquent is now lower than the peak in January 2010. (Bloomberg)

Bank of England credit plan shows signs of cutting UK funding costs

Dec 18. The Bank of England (BOE) said that the Funding for Lending Scheme (FLS) has successfully helped to lower the cost of funds for banks and improved the flow of credit in the economy. The FLS provides a convenient channel for funding and should increase future spending and investments by consumers and corporations. The recent growth in money supply in the UK was a result of the FLS and bond purchase programs. Moreover, sentiment in financial markets has improved partly because of the ECB's bond buying pledge. (Bloomberg)

Potential credit-rating downgrades reach 30-month high

Dec 18. Standard & Poor's (S&P) said that the number of issuers it covers which it may downgrade is the highest in 30 months. In a research note to clients, S&P said that 613 ratings could be downgraded in November compared to 599 in October. Banks account for 18% of the potential downgrades, out of which half of them conduct businesses in Europe. The difference in the number of issuers pending upgrades and downgrades is also the largest since May 2010, which S&P says is a result of the European sovereign debt crisis. In related news, S&P upgraded the Greek sovereign credit rating to B- from SD on December 18, following the completion of the recent bond exchange. (Bloomberg)

Euro Crisis growth pains prompt rate cuts from Sweden to Turkey

Dec 18. Central banks in the largest neighboring countries around Europe have cut interest rates in view of the problems stemming from the European debt crisis. In Sweden, lower demand caused the central bank to lower interest rates in view of falling exports to the rest of Europe. Both Hungary and Turkey have also cut interest rates in lieu of a lower growth outlook in Europe. Other central banks like the Bank of Japan, the US Federal Reserve and the Bank of England have resorted to unconventional policies to stimulate growth after already bringing down interest rates in their countries. (Bloomberg)

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Contributing Editor: James Weston