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Sprinting ahead of its competitors

by Kenny LIEW

After reporting a net loss of nearly USD 1bn at the end of 2015, Sprint is now poised to complete what would be a remarkable turnaround in the competitive US telecommunications industry. Although its revenue remained stable, Sprint has decreased its loss to USD 142mn in the third quarter of 2016. The market capitalization of the carrier has more than doubled YTD, and more than tripled from its lowest point this year, while the RMI-CRI 1-year PD has declined to 19.35 bps from 169.7 bps at the end of January– a marked 88.59% drop. Sprint is the fourth largest carrier in the US, in an industry which is effectively a four-horse race. Sprint had 58.4 million subscribers as reported in Q2 2016, trailing the 142.8 million of Verizon, 131.8 million of AT&T, and the 67.4 million of T-Mobile– the other big names in the US telco industry. US Cellular, the smallest player, trails considerably with only 4.98 million subscribers.

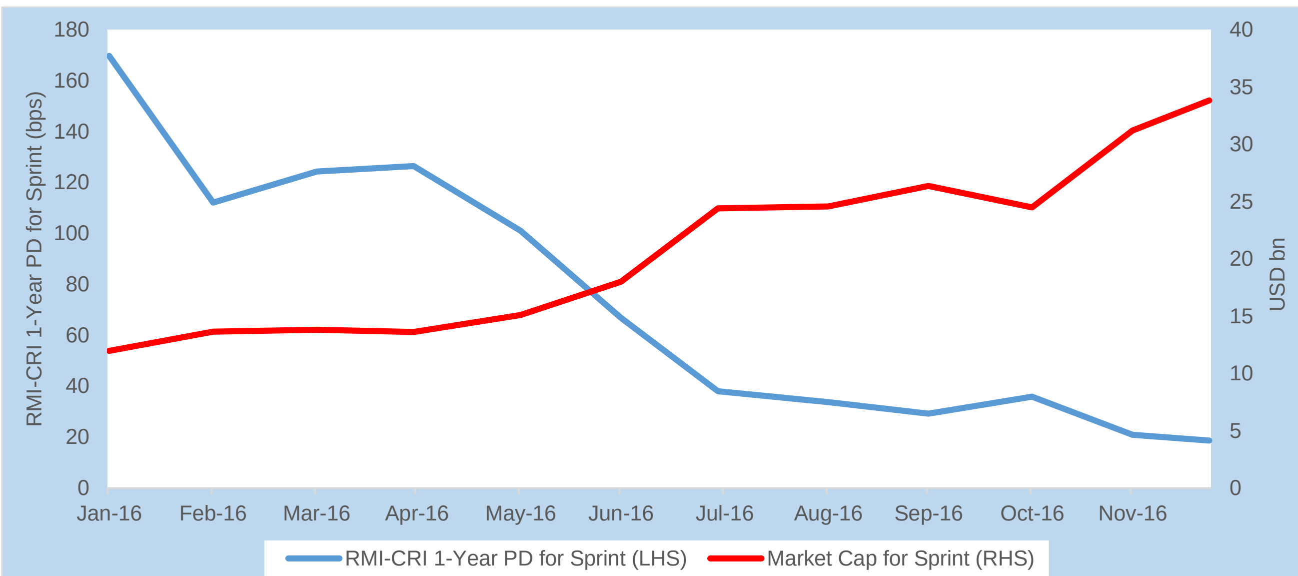


Figure 1: RMI-CRI 1-year PD for Sprint (LHS) and market capitalization of Sprint (RHS). *Source: RMI-CRI, Bloomberg*

Sprint's changing fortunes can be attributed to multiple factors – but CEO Raul Marcelo Claure's aggressive undercutting tactics and restructuring strategy must be given a fair share of the credit. Claure, who took the reins in 2014, cut the prices of mobile plans to half of its competitors' prices – a move received well by the market, which responded by contributing 347,000 new postpaid subscribers to Sprint in Q2 2016, the fifth straight quarter of gains for the company. AT&T, in contrast, lost 180,000 subscribers in the same quarter.

Postpaid average revenue per customer (ARPU) – an important metric in the industry -- grew to USD 49.88, beating the USD 46.98 reported by the industry leader, Verizon. Sprint's strategy likely persuaded customers to subscribe to more plans at lower rates – thus increasing APRU. Cost-cutting efforts saw the carrier slash 2,500 of its workforce, resulting in savings of over USD 2bn – all contributing to the bottom line.

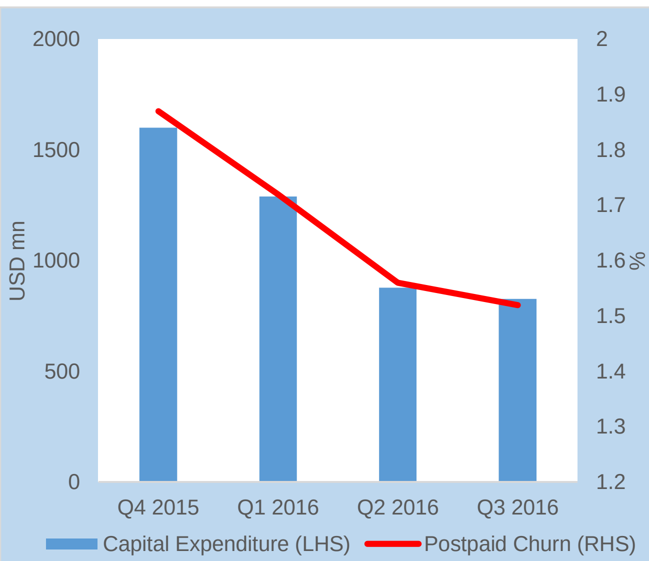
	Q4 2015	Q1 2016	Q2 2016	Q3 2016
Revenue (USD mn)	8,107	8,071	8,012	8,247
EBIDTA (USD mn)	2048	2158	2577	2458
Free Cash Flow (USD mn)	-795	4	-336	880
Net Income (USD mn)	-836	-554	-302	-142
Net Debt/EBITDA (x)	4.34	4.23	4.17	3.64
Cash to Total Assets (%)	2.73	3.34	4.70	4.96

Table 1: Financial data for Sprint Corp. *Source: RMI-CRI, Bloomberg*

In a move away from issuing debt, Sprint resorted to a less than conventional strategy to raise funds. The company raised USD 2.2bn in April 2016 via a [lease-buyback arrangement of its wireless airwaves](), and is planning to borrow a further USD 3.5 bn. Through this arrangement, the company mortgages a portion of its infrastructure for cash, and leases it back for its own use. The notes, collateralized by the airwaves, have been rated investment grade by Moody's and Fitch. Its Net Debt/EBITDA has been steadily decreasing over the year as a result of the scheme, and cash to total assets has been consistently trending upwards.

Sprint is majority-owned by SoftBank Group – the Japanese telco and Internet giant, whose CEO Masayoshi Son recently met President-elect Donald Trump and announced a USD 100bn technology development fund. The announcement was met with a 6.1% surge in Sprint Corp's stock prices, as investors see warming relations between Son and the President-Elect as an advantage for the company. Analysts predict that warming relations could see Trump allow Sprint and T-Mobile to go through with their proposed merger, which was continuously sanctioned by the Obama administration on antitrust grounds. Trump's presidency could also bring along a reversal of the Federal Communication Commission's (FCC) net-neutrality order, which would result in a reduction in the agency's broad power to regulate broadband services.

Although the early signs indicate a turnaround, tough times still lie ahead. Competition from wired carriers – namely from Comcast and Charter also threaten to further diminish the contribution of wired services, currently accounting for 7.3% of Sprint's total revenue, compared with 8.0% in 2015. With price competition expected to persist well into 2017, Sprint must look into other areas to differentiate its offering in a largely homogenous market. The carrier is banking on the deployment of its 2.5GHz spectrum to progressively expand its capacity by utilizing idler frequencies using new software rather than more hardware, thus reducing its capital expenditure. This will also improve service and coverage, which may help the company maintain its decreasing postpaid churn rate trend -- the rate of customers leaving the carrier. The progressive improvements coupled with the price cuts in the past have resulted in both capital expenditure and postpaid churn rates moving in a downward trend (Figure 2).



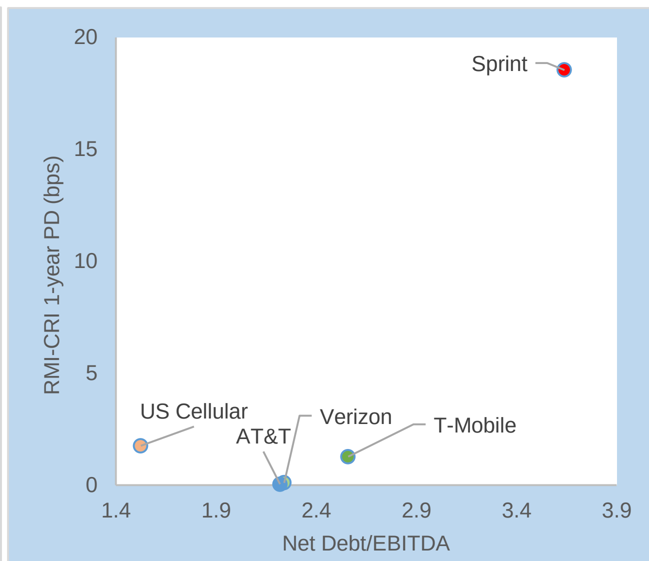


Figure 2: Capital Expenditure (LHS) in USD mn and Postpaid Churn rate (RHS) for Sprint Corp. *Source: Bloomberg*
Figure 3: RMI-CRI 1-year PD (data as of Dec 22, 2016) against Net Debt/EBITDA (Q3 2016) for major US wireless providers *Source: RMI-CRI, Bloomberg*

On the credit front, Net Debt/EBITDA has fallen considerably, but is still significantly higher than the industry average of 2.44. Similarly, the PDs of all its competitors are evidently lower. A plot of the RMI-CRI 1-year PD against Net Debt/EBITDA can be seen in Figure 3.

All things considered, Sprint's financial condition seems to be on an uptrend. Progressive roll-outs of its service improvements and restructuring of its business will help its profitability and reduce postpaid churn. A warming political environment will also serve to boost the performance of its business. However, Sprint must also play its cards well and rely on new, novel ideas to improve its business and surge ahead of other players in the industry.

Credit News

1MDB's debt restructuring plan hits snags

Dec 23. A debt restructuring plan at scandal-torn 1Malaysia Development Berhad (1MDB) is stalling over delays in the disposal of real asset assets and dispute with Abu Dhabi involving more than USD 6.5bn in debt obligation. Executives involved in the plan said that governments officials from both countries have been in private talks to reach a settlement to avoid a messy arbitration battle. Both parties had reached a tentative agreement that Malaysia would settle roughly USD 1.2bn of the disputed amount. However, the Malaysian counterparty seemed to have a change of heart, which will likely result in an arbitration according to a financial executive involved in the negotiation. (Straits Times)

Italy cabinet approves Monte dei Paschi bailout

Dec 23. Monte dei Paschi di Siena (MPS) managed to secure temporary financial support from the Italian government only after raising just EUR 2.5bn in private funds, below the EUR 5bn requirement the bank needed. Government officials hope that the EUR 20bn bank bailout package will instill confidence in MPS and other struggling Italian financial institutions. MPS shareholders and junior bondholders will share some of the financial losses to mitigate the impact to taxpayers. The bank rescue comes at a time when Italy is having one of the highest ratios of debt to GDP in Europe standing at 133%. The EUR 20bn bailout will amount to 1.2% of Italy's GDP making it difficult to manage its debt under EU budget rules. (FT)

Alibaba fintech affiliate tripped up by China bond default

Dec 22. A USD 45mn corporate default in China this month is raising questions about the quality of investments at Ant Financial Group, a financial group linked to Alibaba Group Holding Ltd. Cosun Group, which sold its high-yield debt products to ordinary investors through Ant, issued notices that it would default on its debt this month. The defaults coincided with a rout in China's bond market following the US Federal Reserve's rates hike. Following the default, Ant is urging various parties to repay investors, and has vowed to cover the legal bills for investors who decide to sue. However, the company doesn't consider itself responsible for repayment since the products were developed by third parties. (WSJ)

Limited room for China to tighten policy as debt fear grows

Dec 22. China's slowing growth which is expected to be 6.7% this year and 6.5% next year has created challenges for its leaders to find a balance to support growth and at the same time, prevent debt from growing too fast. When the Chinese leaders met last week for their annual Central Economic Work Conference, the key theme was to deal with asset bubbles and financial risks. The People's Bank of China (PBOC) which has been directing money market rates higher is expected to maintain benchmark interest rates before consumer inflation reaches 3%. China's debt to GDP ratio was 250% at the end of 2015 according to IMF and with RMB 11.6tn in loans issued so far this year, it has beaten last year's record of RMB 11.72tn. Outstanding loans has also rose from 135% of GDP in 2014 to 145% in 2015 and this is set to cross 150% of GDP in 2016 according to Reuters calculations. As Jia Xiaojun, senior analyst at Industrial Securities, put it "(The government) won't tighten things up too much, otherwise the economy could take a big hit from financial stress, which I don't think they want." (Reuters)

PBOC's shadow banking curbs risk deepening junk bond rout

Dec 21. The People's Bank of China risks deepening the junk bond rout by introducing a new set of accounting rules which will include wealth management products held off bank balance sheets in its framework. The move which will kick in in the first quarter of 2017 will curb Chinese lenders from circumventing risk-control rules, and allow the central bank to better gauge risk in the banking sector. However, coupled with an increasing yield gap between top-rated and lower-rated bonds, the move will likely cause smaller companies – seen as riskier – to raise funds from banks. At least 28 onshore bonds have defaulted in 2016, compared with only 7 in 2015. A massive RMB 102.8bn of bond sales have also been called off or postponed in the last month of this year – RMB 81.1bn more than the whole of November. (Bloomberg)

Modular Space files for bankruptcy in US and Canada (WSJ)

Limited Stores is said to plan for bankruptcy and possible liquidation (Bloomberg)

Regulatory Updates

EU bank sector exceeds liquidity rules ahead of deadline

Dec 21. The European Union banking sector has managed to meet new liquidity rules, known as the liquidity coverage ratio (LCR), ahead of the January 2018 deadline. The new rule requires banks to hold enough cash and top quality securities to last a 30-day outflow of funds. The objective is for banks to hold enough cash to meet immediate demands without eating into their core capital. The European Banking Authority said that 90% of the banks sampled complied in full with only three not meeting the current LCR requirement of 70%. (Reuters)

Banks loosen lending standards for fourth straight year: US regulator

Dec 20. The Office of the Comptroller of the Currency (OCC) in its annual survey found that large US banks have loosened underwriting standards – mostly in consumer loans, conventional home equity, commercial real estate loans and residential mortgages. This is the fourth year in a row where the standards were loosened -- raising the possibility of an accelerating increase in credit risks if the trend continues. Increasing competition from other banks and nonfinancial firms and an increasing appetite for expansion are seen as reasons of the increasingly lax standards. Banks are also relying less on derivatives and loan sales to manage credit risks. Approximately 24% of banks introduced new loan products – with a further 23% planning on new offerings this year. (Reuters)

Swiss regulator fines banks USD 96.3mn for rate rigging (WSJ)

Australian regulator investigates Slater & Gordon (FT)

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Contributing Editor: Victor Liu