Credit Research Initiative
Risk Management Institute, National University of Singapore
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Weekly Credit Brief
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SNC-Lavalin faces increasing credit risk amid business problems and upcoming debt repayment

By Zhou Ye

SNC-Lavalin Group Inc. (SNC), a leading Canadian engineering and construction company, is facing several debt maturities over the next few years. SNC is required to repay CAD 1.2bn this year and CAD 0.5bn in the subsequent two years, which combined accounts for 46% of its total debts. However, the NUS-CRI 1-year historical Probability of Default (PD) witnessed a sharp increase, rising to roughly twice the value of the Canadian average, signifying increased credit risk. Possible cause for this may not only lie in the aforementioned debt repayments, but also in other business situations as well.

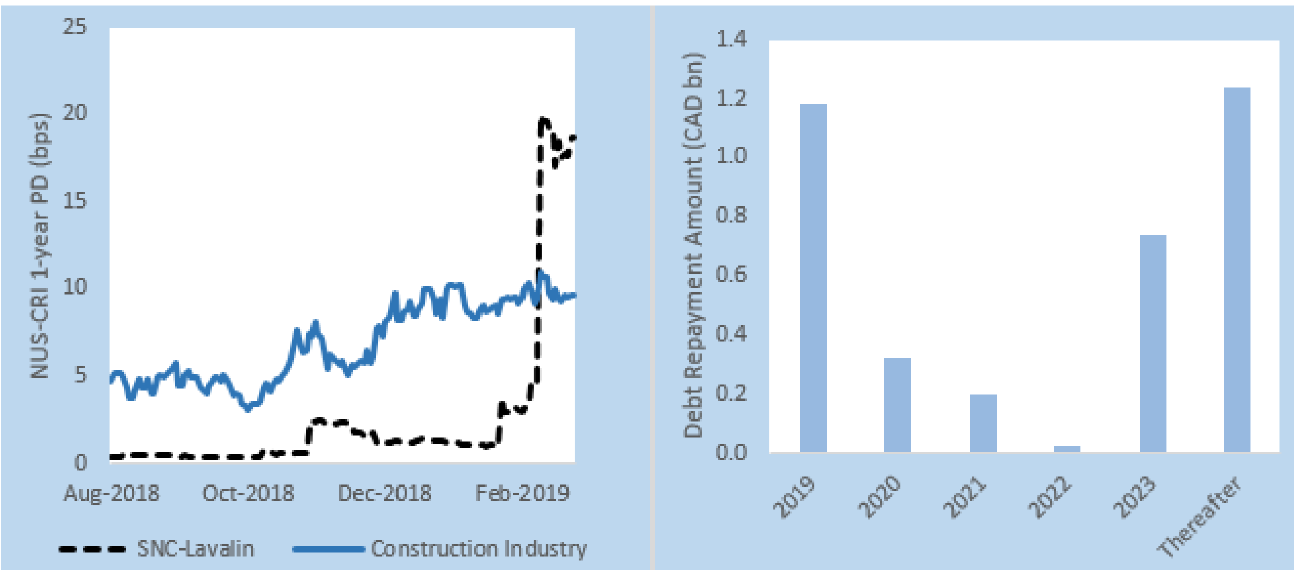

Figure 1a (LHS): NUS-CRI 1-year PD for SNC-Lavalin Group Inc. and Aggregate 1-year PD for Canadian Construction Industry. *Source: NUS-CRI.*
Figure 1b (RHS): Debt repayment schedule for SNC-Lavalin Group Inc. *Source: Bloomberg.*

SNC has been under the woes of a potential fallout from fraud charges in Canada, the company's largest market segment, contributing 30% of its total revenue last year. The investigation towards its payments to secure contracts in Libya from 2001 to 2011 may lead to a result of 10-year ban on Canadian federal contract. Besides, the company announced profit warning on 28 Jan and 11 Feb due to a failure to reach an agreement with a client in a dispute over a mining project in Latin America, and prompted to slash its profit forecast for more than 40% for the year. Unsurprisingly, following the announcement, SNC's bond price plunged that day. In addition to the fraud charges, the geopolitical tension between Canada and Saudi Arabia continues to escalate. Saudi Arabia froze diplomatic ties and new business deals with Canada, causing SNC to incur a goodwill impairment charge about CAD 1.24bn after-tax, about CAD 7.04 per share, on the carrying value of its oil and gas business. Saudi Arabia is the third largest market for SNC, accounting for over 10% of total revenue last year. With the headwinds it faces, SNC's EBITDA margin falls from 10.12% in Q3 2018 to -58.42% in Q4 2018.

Facing the looming debt maturity and business issues, the NUS-CRI Forward 1-year Probability of Default (Forward PD) for SNC-Lavalin Group Inc. rises sharply. The Forward PD computes the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 10-month forward 1-year PD is the probability that the firm defaulted during the period from 10 months onwards to 1 year plus 10 months, conditional on the firm's survival in the next 10 months. As illustrated in Figure 2a & 2b, based on the market information available on 1 Mar 2019, the credit profile for SNC is expected to deteriorate in the next few years. The forward PD increased from its current value of 20 bps to over 90 bps in 30 months. Besides the overall increase compared with the forward PD on 31st December 2018, the trend of curve also becomes much steeper in the next two years. The gap between SNC and the industry benchmark reaches the largest in approximately two years. This may be due to the CAD 1.7bn debt maturity in the next three years, especially the CAD 1.2bn repayment this year. To refinance, the company may issue new bonds or borrow from banks, but considering the business issues and relatively weaker performance of the company, investors may demand higher interest rates, leading to higher refinancing cost. This may be one of the reasons behind the relatively steeper increase of the Forward PD in the next two years.

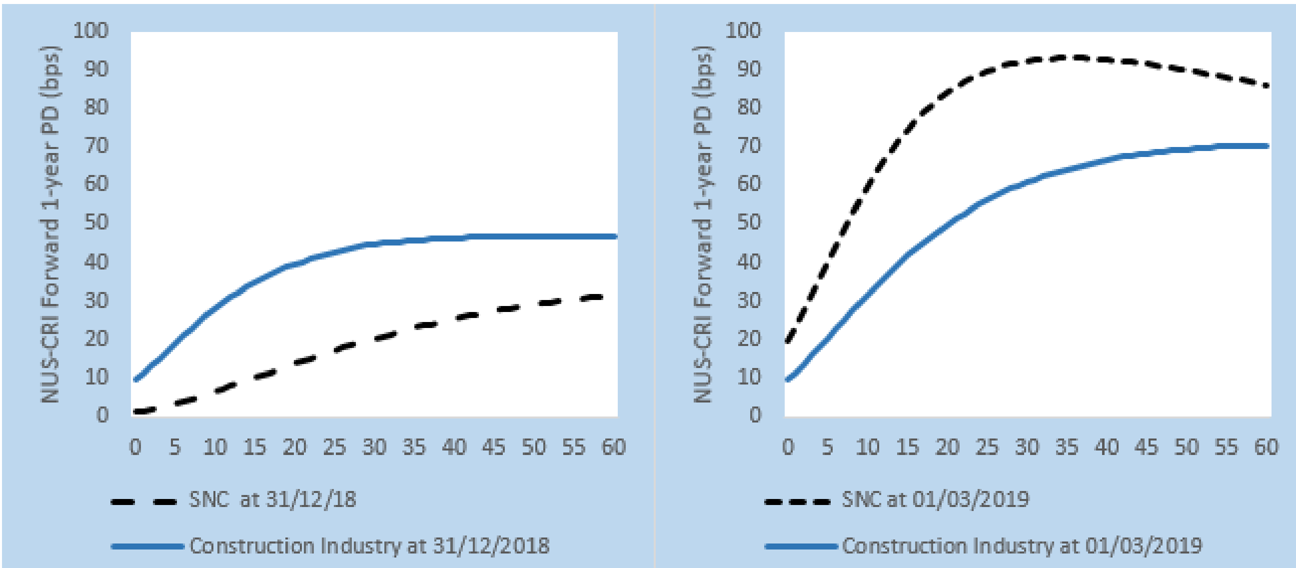

Figure 2a (LHS): NUS-CRI Forward 1-year PD term structure for SNC-Lavalin Group Inc. and Canadian Construction Industry on December 31, 2018. *Source: NUS-CRI*
Figure 2b (RHS): NUS-CRI Forward 1-year PD term structure for SNC-Lavalin Group Inc. and Canadian Construction Industry on March 1, 2019. *Source: NUS-CRI*

Overall, under the pressure of current business problems due to the potential penalty of the fraud charges and the upcoming debt maturity, SNC faces higher credit risk in the next few years as seen from the NUS-CRI Forward PD. Currently, SNC is seeking ways to increase liquidity. According to SNC, the possible strategy includes disposal of its stake in the operator of a toll road north of Toronto – 407 International. Cutting the stake from 17% to 10% can help raise about CAD 2bn. Selling the Saudi Arabia asset may be another choice for SNC, if the tension between Canada and Saudi Arabia keeps escalating.

Credit News

Emerging market default rates remain low despite crises

Mar 2. Despite adverse economic conditions in 2018, which ranged from recessions to international trade wars, emerging markets have not shown an increase in corporate bond default rates during the year, according to Moody's. Amidst other factors, US interest rate rises and the resulting increased currency volatility did not appear to impact the emerging markets as negatively as some had previously feared. Instead, the developing economies exhibited similar default rate levels as their more developed counterparts. However, forecasts made by Fundamental Intelligence, an investment consultancy, suggest a decline of the situation in late 2019 and beyond, with higher default rates expected especially for China and Argentine. (FT)

China's fledgling junk bond market spawns new breed of vulture funds

Mar 1. A new flock of vulture investors have emerged in China's corporate bond market last year, seeking to profit from the decline in fixed income prices. The emergence of vulture investors was spurred by a record number of delinquencies in 2018. When there is bad news about issuers, mutual funds dump their bonds and vulture funds will buy them at a low price, betting that the company will eventually repay the debt. Distressed debt investing is a risky business as there is a lack of transparency in company disclosures in China but investors can expect to earn a high rate of return on their investment. (Reuters)

IMF extends Sri Lanka loans programme in respite for Colombo

Mar 1. After a period of political uncertainty in Sri Lanka in 2018, during which the country's prime minister Ranil Wickremesinghe was temporarily replaced and later reinstated, the International Monetary Fund (IMF) has granted the country a one-year extension on its $1.5bn loan programme. This extension comes in the wake of recent downgrades by major rating agencies and has the goal of providing the opportunity for implementing stabilizing political and economical measures, according to the IMF. (FT)

Italian bank bond binge revives fears of sovereign 'doom loop'

Feb 27. Banks across Italy have begun the year by piling back into the domestic government bond market, in a move that could amplify fears of a "doom loop" between the country's sovereign bond yields and its lenders' balance sheets. When debt prices fall and yields rise, banks are forced to reprice their holdings and may have to reduce lending and raise capital to survive — further undermining the health and stability of their home country. However, banks' ownership of sovereign debt is "a bit of a double-edged sword". Having a strong base of domestic investors can be beneficial for governments in times of market stress. (FT)

Corporate America goes on debt diet after USD 3tn binge

Feb 27. In preparation for an anticipated recession, several large US-based companies have announced plans for lowering their current debt load in 2019. Considering the increase in average corporate bond risk and rising corporate debt levels in the US since the 1990s, the measure of lowering credit risks may soften the detrimental impact of a future economic downturn. This, however, is not the only cause: according to several investment experts, the interests of both stock and bond shareholders, united by the fear of unmanageable liability levels, have led to a rise in share prices for companies with a lower borrowing load. The opportunity of an increase in share price is therefore currently incentivizing other companies to follow suite. (Bloomberg)

UK government debt sells off most since 2017 with Brexit in focus (FT)

Saudi Aramco faces key test of demand in global debt markets (FT)

In rare default, Chinese state-owned firm misses bond payment (WSJ)

Regulatory Updates

Basel Committee calls for external checks on bank loans

Feb 28. External checks on the riskiness of banks' loans has been called as the fallout continued from an accounting failure at the UK's Metro Bank, a small but fast-growing UK lender. Metro Bank was revealed in January to have miscategorised a range of mortgages, and thus made evidence of mistakes in calculating its risk-weighted asset (RWA) numbers, which are decisive in determining how much equity capital a bank must have. Capital levels are key to banks' robustness. Basel committee had a longtime concern over large unexplained divergences in the way different banks appear to judge the riskiness of similar loans and there is currently no external check on how the RWAs are calculated from year to year. (FT)

EU agrees tough post-Brexit financial services rules

Feb 27. In the face of nearing Brexit deadlines, the EU has announced its new set of guidelines and regulations that will govern the access of outside financial service providers to the single market. With London as a world centre of the financial industry, its continued operation within European borders will only be possible within a strict framework of rules and requirements, such as a continued supervision and evaluation of any granted access by the European Commission depending on the equivalency of rules present in the partnered economy. Not limited to the United Kingdom however, these new rules are set to apply to all non-EU financial service providers and will go into effect from 2020 on, European officials expect. (FT)

Bank of Italy attacks EU bail-in rules for banks (Reuters)

China opens to foreign credit raters to boost bond credibility (Bloomberg)

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