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ZTE woes created opportunities for its rivals

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On July 3, US President temporarily relaxed some of the trade restrictions on ZTE Corp (ZTE) after the company removed 7 executives and agreed to pay the USD 1bn penalty. ZTE is China's second largest telecommunications equipment maker and one of the largest telecommunications equipment makers in the world. In April, the firm was blocked from buying American components and forced to stop its major operations after the Commerce Department said that ZTE violated American sanctions against Iran and North Korea. ZTE's stock was suspended from April 17 to June 13 and lost more than 40% of its value on the day it resumed trading. The RMI-CRI Forward 1-year PD (Forward PD) term structure in Figure 1a shows how the shape and level of Forward PD changed from April 16 to July 6, reflecting the negative impact of the US sanctions on ZTE's credit profile.

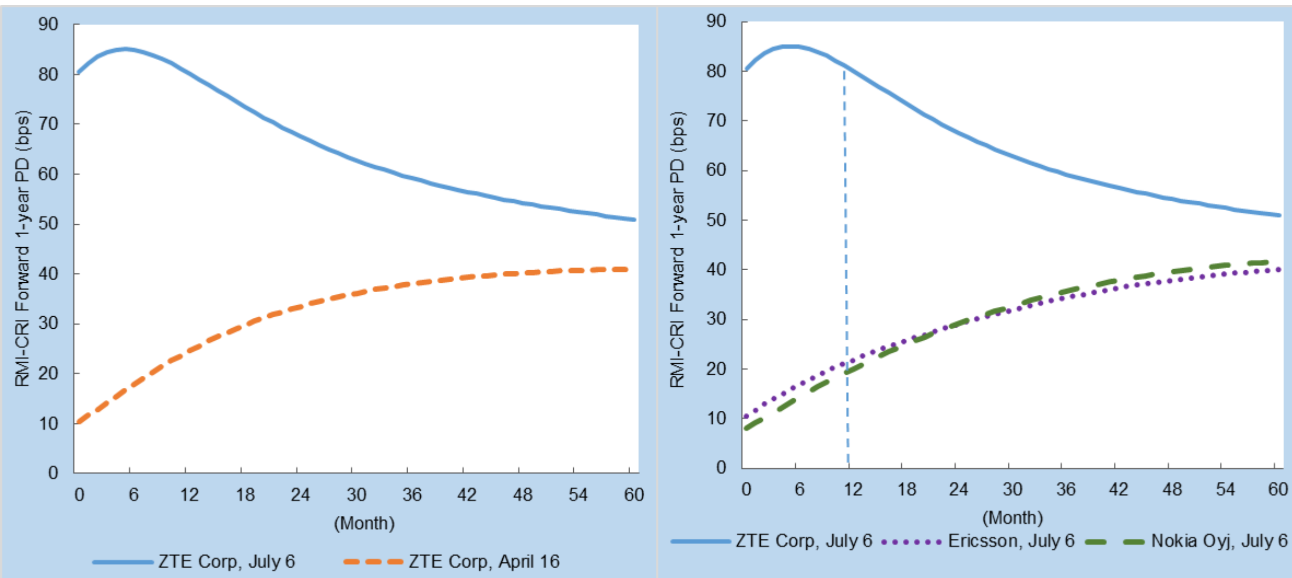

Figure 1a (LHS): RMI-CRI Forward 1-year PD term structures for ZTE Corp on July 6 and April 16, 2018. Figure 1b (RHS): RMI-CRI Forward 1-year PD term structures for ZTE Corp, Ericsson and Nokia Oyj on July 6, 2018. *Source: RMI-CRI*

At the end of 2017, ZTE held a market share of 13% in the telecommunication equipment market, ranking it No. 4 in the world, behind Huawei Technology Co., Telefonaktiebolaget LM Ericsson (Ericsson) and Nokia Oyj (Nokia) with market shares of 28%, 27% and 23%, respectively (see Figure 2a). Ericsson and Nokia's market shares both lost 1% compare to 2016, which mainly resulted from higher competition from their Chinese rivals Huawei and ZTE. On July 4, ZTE lost a deal worth of USD 600mn (about 13% of ZTE 2018 Q1's revenue) to supply wireless equipment to Italian operator Wind Tre, and the contract was awarded to Ericsson. ZTE lost the deal because the firm could not acquire US technology, which gave Ericsson the lead in the deal.

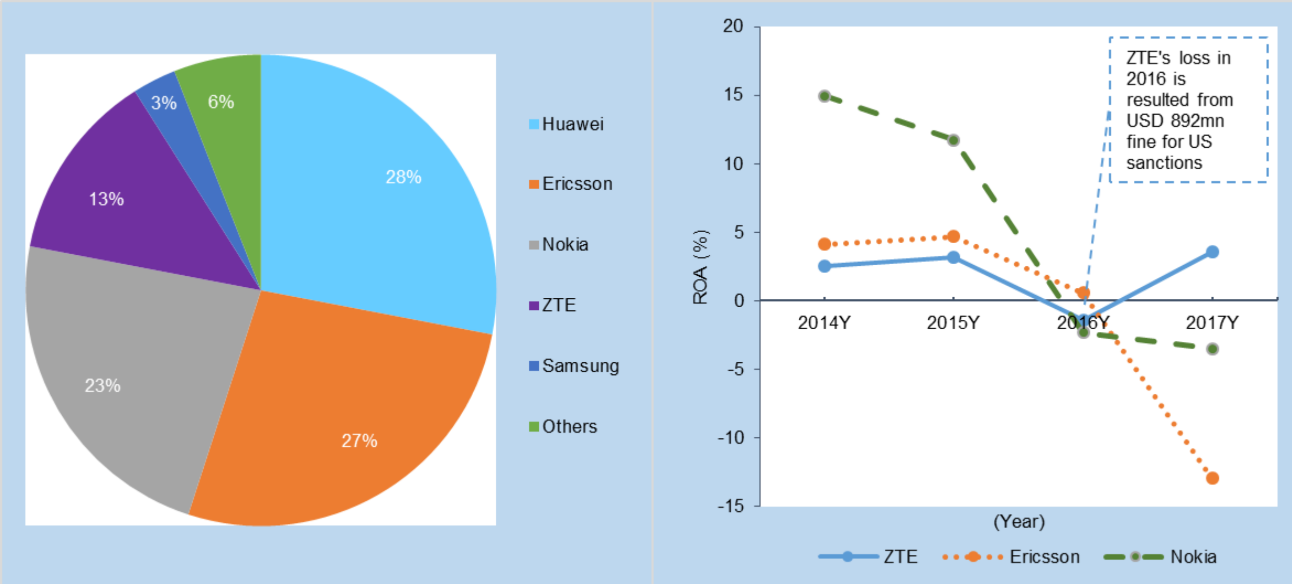

Figure 2a (LHS): Global market share of telecommunication equipment makers as of December 2017. Figure 2b (RHS): Net income trend of Ericsson and Nokia from the year 2014 to 2017. *Sources: IHS Markit & Bloomberg*

	ZTE	Ericsson	Nokia
12 Months Ending	**03/31/2018**	**03/31/2018**	**03/31/2018**
Operating Margin (%)	6.42	-13.17	-0.85
Return on Assets (%)	3.94	-9.10	-2.85

Table 1: 12 months ending financial figures for ZTE Corp, Telefonaktiebolaget LM Ericsson and Nokia Oyj as of 03/31/2018. *Source: Bloomberg*

As shown in Figure 2b, Ericsson and Nokia have shown a declining trend in ROA from the year 2014 to 2017. Before April 2018, ZTE achieved more than USD 16bn in revenue over the 12 months ending as of March 31, 2018, and had better profitability ratios than Ericsson and Nokia which suffered losses due to restructuring costs and integration of acquired assets, respectively (see Table 1 above). Ericsson and Nokia still face challenges like intense competition from other rivals, especially Huawei with their aggressive pricings, and slowing market demand. In Figure 1b, the term structures of the Forward PDs for Ericsson and Nokia Oyj showed increasing credit risk profiles for the firms in the next five years, based on market information on July 6. The Forward PD works similarly to a forward interest rate. For instance, the 3-month Forward 1-year PD is the probability that the firm defaults during the period from 3 months onwards to 1 year plus 3 months, conditional on the firm surviving the next 3 months. The increasing Forward PDs for the two companies indicate that the conditional credit risk of each firm will gradually increase as time passes.

The term structure of the Forward PD for ZTE shows an increasing default risk with time to peak at around 5 months and then declining afterward, based on market information on July 6. Moreover, the term structure suggests that if ZTE can survive for the next 12 months, its 1-year PD will return to the current level and the credit outlook will continue to improve in the long run. However, more time may be needed for a meaningful credit recovery, given the huge penalty to pay, switching cost to the new component suppliers, and efforts required to rebuild trust from its consumers.

In all, the sanctions from the US government did force ZTE into a desperate situation that created benefits for its rivals in the short run. However, ZTE still gets a chance to recover its business in future and compete with Ericsson and Nokia again.

Credit News

A peculiar practice in Japanese bond sales hurts investors and banks

Jul 9. If a bond sale does not attract enough demand in Japan, underwriters may keep the unsold issues for themselves and declare that the bond was sold out. This phenomenon, also known as the retention system benefits issuers at the expense of investors and underwriters. Banks, or underwriters sometimes offload the unsold portions of the bond at a loss, as they do not want the issuers to know if the bond notes failed to attract enough demand. However, more issuers are slowly adopting the pot system used for most European and US bond issues, where underwriters share details about buyers with the issuers to find the best bids. (Bloomberg)

Adjusted Ebitda masks higher leverage on buyout loans

Jul 9. There is a rising concern among investors in European leveraged loans that aggressive adjustments made on companies' earnings are masking the true amount of leverage and debt that private equity firms are using, so as to hide the inherent risk in transactions. Higher Ebitda figures allow companies to borrow more, which also make overall leverage levels lower and make deals easier to sell to investors. The European Central Bank and US regulators are capping leverage ratios at six times Ebitda, however, even leverage levels after adjustments are usually higher than that. Investors are criticizing the scale of current Ebitda adjustments and demanding changes, as resistance to aggressive loan documents grows. (Business Times)

Rising loan pricing creates challenges for big US buyouts

Jul 7. Large US buyout loans are facing a more challenging environment as loan pricing is rising this year. A series of numerous new issuance in May and June has provided investors with more options, which leads to a less predictable market and a wider pricing spread to an average of 400 bps from 325 bps in prior. Total new money loans in May reached USD 33.5bn while June recorded USD 54.2bn, the biggest monthly total since September 2017. Some buyout loans are requiring revisions such as higher pricing, more call protection and documentation changes, while other transactions are clearing the market easily, as investors focus on credit fundamentals ahead of an anticipated downturn as US interest rates rise and the elongated credit cycle draws to an end. (Reuters)

China energy default puts USD 4bn in bonds at risk

Jul 6. Wintime energy, an energy and petrochemical group listed on Shanghai exchange defaulted on a bond payment which has put USD 3.9bn at risk in outstanding bonds. Wintime missed payment on an USD 230mn one-year commercial paper that matured last Thursday. Chinese bond defaults have been on a rise lately and this abrupt increase has led to widened credit spreads in both China and US bond markets. The defaulted bonds also include a USD 500mn bond issued last year with maturity in May 2020. (FT)

China set for record defaults, and downgrades tip more pain

Jul 3. China is on its track to a record year of corporate-bond defaults as two quarters in 2018 have recorded more than three-quarters of the previous high. An expected downturn with the trend of credit rating agencies downgrading firms by an unprecedented margin may aggravate the number of corporate-bond defaults which has reached 20 domestic bonds amounting to CNY 66.3bn at the end of May. Meanwhile, rising yields will make the refinancing of maturing debt tougher for private companies that lack the access to the state-dominated banking system. Despite the escalating downturn, Chinese regulators are reducing intervention in rescuing struggling companies. Directors from the State Administration of Foreign Exchange and S&P Global Rating in Hong Kong asserted that corporate-bond defaults are necessary for long-term development of Chinese bond market and better credit-risk pricing. (Bloomberg)

Turkey's Bereket is said to begin sales to pay USD 4bn debt (Bloomberg)

Italy's debts to European Central Bank near EUR 500bn (FT)

S&P warns NAFTA 'retreat' could trigger Mexico rating cut (Reuters)

Regulatory Updates

Basel Committee issues revised G-SIB framework

Jul 5. On July 5, 2018, The Basel Committee on Banking Supervision issued revised Global Systematically Important Banks (G-SIB) assessment methodology and implemented higher loss absorbency requirement. The primary objective of the new framework is to require G-SIBs to hold higher capital buffers and providing incentives for such firms to reduce their systemic importance. A number of enhancements to the G-SIBs framework which includes the extension of the scope of consolidation to insurance subsidiaries and the introduction of a trading volume indicator in the substitutability category have been agreed. The next review will be completed by 2021 before being implemented in member jurisdiction at the same year. (BIS)

Central banks find prolonged low interest rates affecting financial stability

Jul 5. The Committee on the Global Financial System (CFGS) discovered that sustained low market interest rates might adversely affect the stability of the financial system and the health of individual financial institutions, such as banks, insurance companies and private pension funds (ICPFs). The impacts include material risks to financial stability, where an unanticipated surge in market rates might upset banks' solvency and ICPFs' liquidity. One possible precaution to counter these risks are to establish stronger financial stability by managing sufficient capital, liquidity and risk management as well as through thorough supervision of institutions' exposures. (BIS)

Irish banks directed to raise capital buffers (FT)

Tightening loan-to-value limits to promote a stable and sustainable property market (MAS)

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