Credit Research Initiative

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Weekly Credit Brief July 22 - July 28

Bombardier reorganizes amid C Series woes

The world's only manufacturer of both planes and trains, Bombardier, is going through a corporate shakeup amid long delays in testing of its C Series planes. As a result of the restructuring, 1,800 jobs will be shed to reduce costs as its Q1 profit dipped by 22% YoY and its cash burn rate rapidly increasing.

The RMI 1-year probability of default (RMI PD) for Bombardier has captured this weak financial situation, rising drastically since the end of Q4 2013 to 55.01bps in February after a string of disappointing results that fell well short of expectations, thus forcing the Company to cut its 2014 annual earnings forecast at the beginning of the year. This financial stress on Bombardier was eased during April, when the company managed to raise an aggregate of USD1.8 bn through issuance of unsecured senior notes. The financial recovery was especially obvious after Bombardier's first Learjet 85 flight test vehicle completed its maiden flight on April 9, 2014, achieving a major milestone of the aircraft development program. However, C Series flight testing halted again after an "engine-related incident" in May, triggering a 2.4% drop in its class B stock price and reigniting the cost issues for the company. This was accompanied by an increase in the RMI PD, which hit a 2½ year high of 57.18bps in May. However, due to the recent corporate restructuring, Bombardier's relative market capitalization recovered, resulting in a decline in RMI PD to 41.16 bps in July.

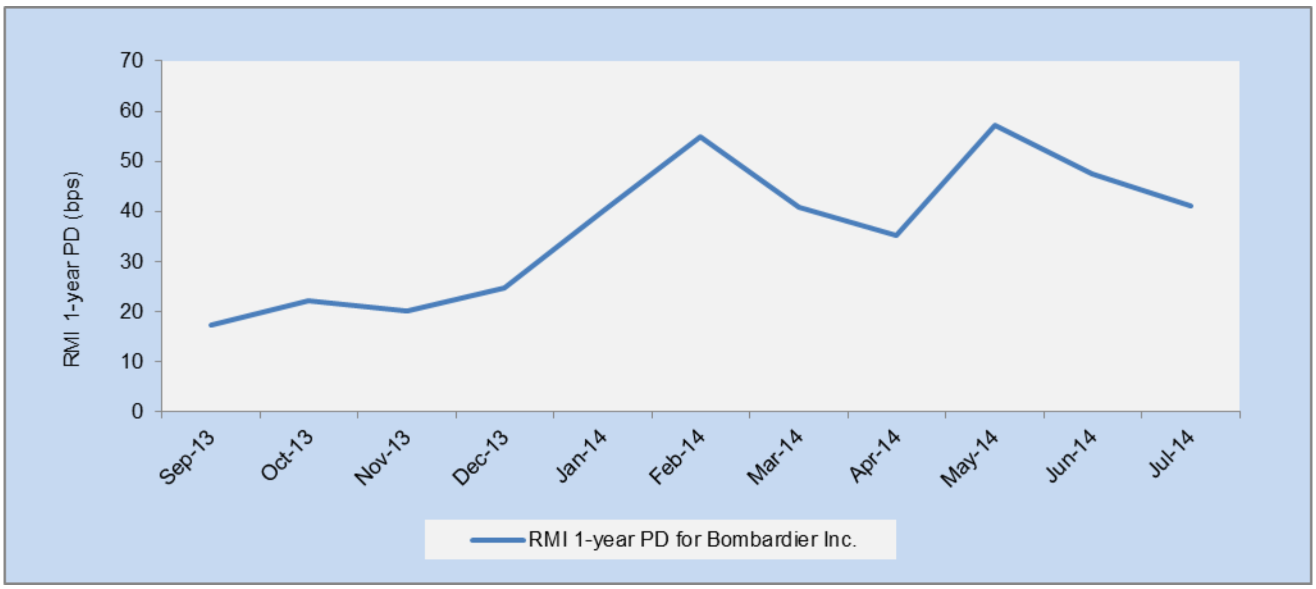

Chart 1: RMI 1-year PD for Bombardier Inc. Source: *Risk Management Institute*

Quarter	Cost of Revenue (USD mn)	Net Income (USD mn)	ROE (%)
Q1-2013	3,723	143	47.21
Q2-2013	3,758	181	51.98
Q3-2013	3,749	145	34.12
Q4-2013	4,698	97	37.31
Q1-2014	3,761	113	35.28

Table 1: Financial Indicators for Bombardier Inc. Source: *Bloomberg*

Serving as an alternative credit risk measure, the situation surrounding Bombardier is also reflected in the RMI Actuarial Spread (AS) - a pure measure of default risk without the influence of risk premium and liquidity based on a recovery rate of 40%. The 5 year RMI AS for Bombardier climbed to 58.97bps at the end of February 2014 and slumped to 53.98bps 2 months later. However, the RMI AS continued its upward climb from April. Corresponding to the movement in RMI AS, the yield for the firm's 5 year 7.5% coupon rate bond increased by 25.3bps between April and July.

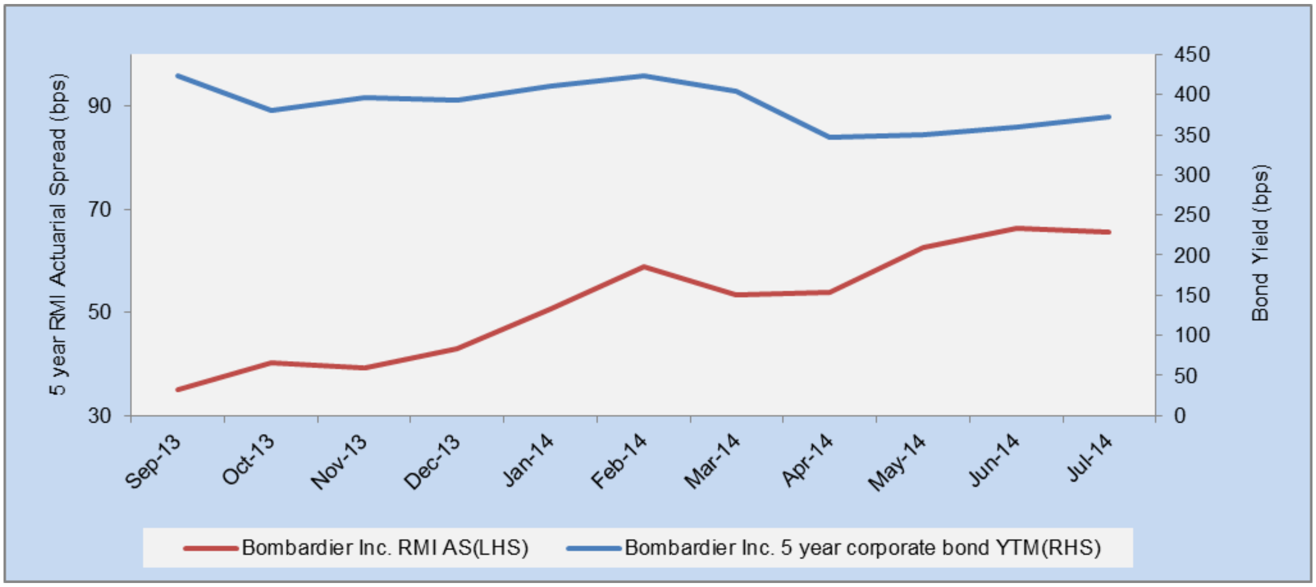

Chart 2: RMI Actuarial Spread for Bombardier Inc. based on 40% recovery rate vs its 5 year USD bond yield to maturity. Source: *Risk Management Institute, Bloomberg*

Bombardier's new corporate structure will take effect in January 1 next year. The reorganized business will be composed of 3 sectors—business aircraft, commercial aircraft and aerostructures and engineering services. The three units, along with Bombardier's rail-industry focused transportation unit, will be headed by separate executives and report to Chief Executive Officer Pierre Beaudoin. The 'lighter' organizational structure gives more agility and flexibility in addressing customer needs, while increasing its focus on growth areas. Besides, this corporate reorganization reduces about 15% of the "indirect functions", including human resources, finance and communication, which is expected to improve the company's cost structure that has been plaguing the Canadian company for a long time.

Credit News

S&P faces fraud charges over mortgage ratings

Jul 24. Standard & Poor's (S&P) received a Wells notice from the Securities and Exchange Commission (SEC) for possible fraud charges over credit ratings issued in 2011. At the time, the SEC charged Mizuho Securities for misleading investors in the S&P rated CDO called Delphinus. S&P later discovered inconsistencies in how its rating methodology was applied to commercial mortgage backed securities, which prompted an investigation by regulators. Credit rating agencies have faced intense regulatory scrutiny after the financial crisis, as rating actions have a direct impact on the actions of investors, borrowers, issuers and governments. (CNBC)

Shanxi brokers deal to avoid Huatong default

Jul 24. China has averted a second corporate bond default after Shanxi construction firm Huatong Road & Bridge met its bond payment of CNY 429mn. The local bailout was reportedly brokered by the Shanxi provincial government and the municipal government of Yangquan. In 2013, Chinese companies have surpassed the United States with USD 14.2tn of debt, becoming the most heavily indebted country in the world. Analysts said that the government's bailout of Huatong was necessary as the company and its creditors were linked in a long chain of credit and this could have a large impact in the bond markets if the company defaulted on the bond. (SCMP)

Espírito Santo Financial Group seeks creditor protection

Jul 24. Espírito Santo Financial Group SA, the holder of a 20% stake in Portuguese lender Banco Espírito Santo SA, has sought creditor protection in Luxembourg for its inability to repay all its debts, after two other Espírito Santo entities, namely Espírito Santo International SA and Rioforte Investments SA, filed for creditor protection within the past two weeks. Espírito Financial Group has been suspended from trading since July 10. (WSJ)

Argentine holdout NML says government 'choosing' to default (CNBC)

China Credit Trust delays payment on USD 210mn product (BusinessWeek)

Regulatory Updates

Regulatory costs seen to cast shadow on lenders

Jul 24. The outlook for the Hong Kong banking sector has turned gloomy, given that increased regulatory pressure has led to rising operating costs as banks may be required to devote more resources to frontline and supporting functions. Revenue growth is also a challenge for banks in Hong Kong, considering the low interest rate environment and uncertainties from the US, European and China. In addition, growth in trade finance may slow down, resulting from the increasing focus on trade activities by Chinese regulators. (The Standard)

Dodd-Frank has made banks safer but slowed economy

Jul 22. The financial reform initiated by Dodd-Frank has led to not only a more stable and capitalized banking system in the United States, but also rising borrowing costs and limited access to bank loans especially for low-income consumers and small and medium enterprises (SMEs), thus giving rise to a more US sluggish economy. Under more stringent lending standards, the cost of financing for SMEs has risen by 175bps more than large companies compared to the pre-crisis period; and the cost of home loans has jumped by 14bps. In Q2 2014, the biggest US banks reported the lowest loan losses in eight years, contributing to better-than-expected bank earnings. (FT)

Insurers wary as Singapore revamps RBC rules

Jul 22. The Monetary Authority of Singapore (MAS) is revising its risk-based capital (RBC) regulations following the Solvency II Directive to introduce adjustment and risk charges for operational risk. Under RBC 2, a credit spread risk requirement will be implemented to reflect changes in credit spreads not brought by defaults or downgrades, leading to higher credit risk charges by several times; equity charges will be raised to 40-50% from 16%. Consequently, insurers will be forced to re-examine their business mix, possibly shifting from traditional participating products to more capital-light products in order to accommodate higher capital charges. Insurers may also struggle to maintain no more than a 15% mismatch in cash flow between assets and liabilities, as assets with long-enough maturity are too limited in Singapore. (Risk.net)

India's new bank regulation for long-term bond issuance is credit positive (Business Standard)

HKMA chief defends strict banking rules (SCMP)

IFRS accounting rules change forces banks to alter view of losses (FT)

Banks to provision earlier on bad loans under new global rule (Reuters)

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