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Puerto Rico's economic crisis clouds outlook for Triple-S Management Corp

by Dexter Tan

Companies operating in Puerto Rico are struggling to stay afloat after the US commonwealth declared bankruptcy in May. Puerto Rico Electric Power Authority, the sole provider of electricity in the island will file for bankruptcy as restructuring talks with bondholders failed to make progress for nearly three years. Both issuer and creditors did not agree on restructuring terms last week as the utility firm rejected a financing offer from bondholders. The economic crisis surrounding Puerto Rico extends to the firms with large presences in the US territory. Earnings of the largest managed care insurance provider, Triple-S Management Corporation (GTS), have turned negative and the credit outlook for the firm hinges on the government's fiscal health.

Last year, the company's contracts with the Puerto Rican government accounted for at least 62.5% of overall revenue. Annual insurance premium rates for the managed care business were established by contracts with government health centers, making the firm's credit quality susceptible to its ability to re-contract on favorable terms. If GTS is unable to renew, or successfully compete for any of the government contracts, the firm's business and creditworthiness may be materially impaired.

GTS may face credit losses in their premium and fee receivables, if the Puerto Rican government fails to raise funding in the market or generate enough revenues. As of Q1 17, the firm had premiums receivables of USD 51.5mn from the government with a related allowance for doubtful receivables of USD 14.1mn. The company's exposure to the Puerto Rico municipals included escrowed bonds with a fair value of USD 7.8mn and senior lien bonds issued by the Puerto Rico Sales Tax Financing Corporation with a fair value of USD 11.22mn.

As a managed care policy provider, GTS also offers life insurance, property and casualty insurance to approximately 1.016mn members. GTS typically receives a monthly payment from members enrolled in their managed care plans. Unlike managed care premiums, revenues on life insurance policy premiums are reported as earned when due, while premiums on property and casualty contracts are recognized on a pro rata basis over the policy term. As shown in Table 1, sales at the firm's managed care business have decreased together with membership enrolments. GTS insured 1.067mn members in Q1 2016 but lost 51,000 members after a year.

	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017
Revenue - Managed care	2793.6	2766.7	2738.3	2686.1	2647.6
Revenue - Life insurance	174	176.8	180.5	181.7	183.3
Revenue - Property & casualty	94.8	94.1	94.8	96.9	97.2
Total medical membership	1,067,000	1,048,000	1,038,000	1,017,372	1,016,000

Table 1: GTS revenue by business segment in USD mn. *Source: Bloomberg, company 10Q and 10K SEC filings*

Managed care, the company's largest and worst performing line of business continued the trend of lower operating profit during recent quarters. The segment made a USD 54.7mn loss in Q1 2017 compared to a USD 8.9mn profit for the same quarter a year before. GTS's ability to accurately predict and manage claims and losses largely determine the segment's operating results. The proportion of insurance costs divided by premiums, or medical loss ratio, has increased due to lower established contractual rates with health care providers and the aging demographic of their members.

	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017
Operating profit - Managed care	8.9	7.6	-12.2	-36.7	-54.7
Operating profit - Life insurance	20.8	20.6	20.5	21.5	19.8
Operating profit - Property & casualty	8.3	9.8	11.2	12.1	12.1

Table 2: GTS trailing twelve-month operating profit by business segment in USD mn. *Source: Bloomberg*

The firm's ability to maintain or grow their membership is driven by general market conditions and the competitive environment. There is strong competition among managed care companies that comprise of local and nationwide entities, including insurance broker subsidiaries of Puerto Rican lenders and financial companies with a strong presence in North America. Increased customer price sensitivity and product awareness have resulted in intense competition as companies compete for the same consumers through price, policy terms and quality of service. There is a possibility that GTS loses its ability to attract or retain customers due to aggressive marketing and sales practices.

Challenging market conditions in Puerto Rico are headwinds to GTS's generation of new businesses. The rate of population loss coincides with the firm's declining memberships and premium revenues. Saddled with USD 72bn of debt, the economy runs a 45 percent poverty rate and has a USD 50bn pension gap. Dismal economic conditions have forced the island's citizens to migrate to the mainland at a record pace. Government figures showed that Puerto Rico suffered a net migration of nearly 360,000 people since 2010, a significant number considering that the island's population was 3.41mn last year.

Another minor aspect of the insurer's credit quality relates to the nature of its investments, which manages the firm's long-term assets and liabilities. GTS does not intend to sell investments at a value below its amortized cost basis as it expects to collect all contractual cash flows from the securities. Although not publicly discussed in the SEC filings, the bonds are supposedly high quality assets with minimal exposure to market volatility. As of Q1 17, the company's fixed income allocation consisted of 18 corporate bonds and 9 US municipal securities. GTS did not record any impairment in investments but there is a risk that continued declines in the portfolio's fair values could occur.

GTS's credit risk profile is meaningfully higher than other managed care insurers listed in the United States. The RMI-CRI 1-year Probability of Default (PD) for GTS exceeded the 1-year aggregate PD for 11 US managed care providers, putting the firm at a significantly higher likelihood of default. According to the CRI Probability of Default Implied Rating (PDiR), a RMI-CRI 1-year PD of 220bps on Jun 30 is equivalent to a B-rated firm by Standard & Poor's rating criteria. The PDiR maps the firm's 1-year PDs to the equivalent S&P letter credit ratings using the historical observed default rates over the past ten years.

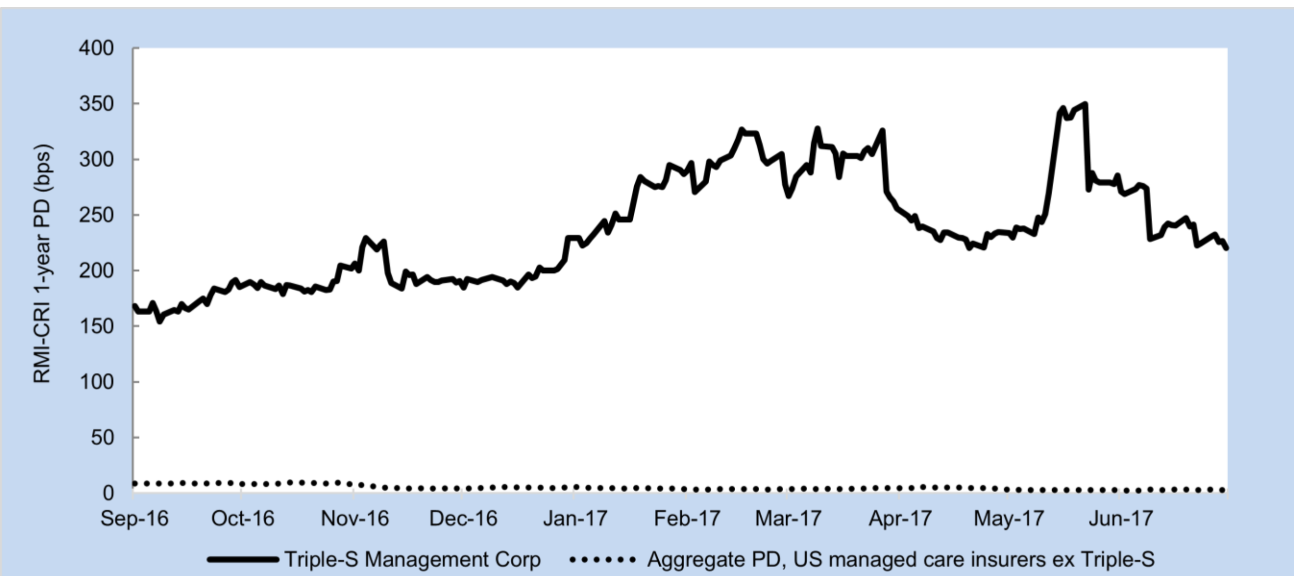

Figure 1: 1-year PD for Triple-S Management Corp vs aggregate 1-year PD for 11 US listed managed care insurers. *Source: RMI-CRI*

In March, the federal oversight board recommended a series of measures to restructure the island's fiscal deficit containing a USD 1bn reduction in health care spending by fiscal 2019, the elimination of budgetary subsidies to municipalities and significant reduction in pension-related benefits. The lawmaker's plan to eliminate subsidies to the municipalities, many of which have contracts for the provision of healthcare with GTS, could materially affect the credit profile of the firm. The firm's default risk may remain at an elevated level as Moody's expects the number of municipal defaults to more than double in 2017 as additional Puerto Rico credits are restructured.

Credit News

Hazy outlook for Singapore economy in second half of 2017

Jul 3. The prospects of an economic rebound in Singapore became uncertain after expectations are revised for sectors that have been driving growth in the first half. Increased demand for exports has accelerated Singapore's growth in the first half of 2017. However, economists are cutting down their expectations for the second half as this growth is turning out to be limited and inconsistent. Electronics manufacturers benefited most from increased trading activities with electronics exports surging by 23.3% in May. Trade-related services also witnessed a growth of 14.3%. However, local growth is lacking with the construction sector shrinking consecutively for the past two quarters and outlook in the oil and gas sector remains bleak under low oil prices. The Ministry of Trade & Industry expects full-year growth to be upwards of 2%. (Straits Times)

Japan firms most upbeat in 3 years but labor shortages weigh

Jul 3. A central bank survey reveals that confidence within Japanese manufacturers is at its highest in 3 years as the economy looks to be headed for a recovery. The survey results are in line with Bank of Japan's belief that the economy is moving towards a moderate expansion. However, business conditions are expected to worsen slightly over the next three months due to uncertainties stemming from overseas markets. Japan's economy saw an expansion of 1% in the first quarter due to robust exports and increase in private consumption. To achieve BOJ's full-year target of 2%, Japan still needs to overcome challenges like capacity and labor shortage. Labor market in Japan is at its tightest since 1992 and the shortage of employees remains a key concern for many companies. (Straits Times)

China Inc's USD 7.8bn of dividend payments will stress the Yuan

Jul 3. July will see heightened risk of volatility in the Yuan as Chinese companies prepare to pay dividends to shareholders overseas, triggering a seasonal increase in demand for US dollars. This can potentially cause a depreciation of the Yuan, after it experienced a brief rally due to suspected central bank intervention. Capital outflows are increasing as the government's deleveraging drive to crimp spending began to slow the economy. Demand for foreign currencies will peak at USD 7.8bn in July, which is significant given that local lenders settled an average of USD 11.8bn in the first five months of 2017. Offshore-listed Chinese firms will need to pay a combined USD 16bn of dividends in foreign exchange in the three months through August, of which USD 2.4bn and USD 5.9bn will be paid in June and August respectively. (Bloomberg)

Bond sell-off fails to derail Fed unwinding plans for QE

Jul 3. Despite weak US inflation figures, the Federal Reserve has yet to shelve its tightening campaign. Mixed signals from central banks across the Euro area and the UK triggered a sell-off in the bonds market and Fed critics have highlighted the latest weak inflation as a signal to halt monetary tightening. US officials have cited falling unemployment rate as a key indicator of future price growth and that the gradual tightening is to remain in place. Analysts have pointed to a possible September shrinking move on Fed's balance sheet and a rate rise in December. Fed policy makers will be keeping a close watch on the coming inflation and employment figures amidst benign market conditions. (FT)

Europe's SMEs risk becoming big losers of 'hard Brexit'

Jul 3. According to a study by Boston Consulting Group and Clifford Chance, 6 in 10 European small businesses only use one bank and most are not ready for the financial implications of Brexit. These small businesses will be the most affected if banks are hit by huge restructuring costs and extra capital requirements in a hard Brexit scenario. The report states that the extra costs will lead to banks reducing the amount of loans and financial market products being provided to European companies. The report also predicts that EUR 1.3tn of bank loans, securities and derivatives will be shifted to rest of the EU and capital requirements for these assets in banks could double to EUR 140bn due to Brexit. (FT)

China manufacturing rose in June amid global upturn (Bloomberg)

Three bank failures barely cool demand for riskiest lender debt (Bloomberg)

Regulatory Updates

MAS unveils credit-rating grant

Jul 1. In an attempt to increase the share of rated bond issuance and improve market transparency in Singapore, the Monetary Authority of Singapore (MAS) has unveiled a grant to encourage companies to issue credit-rated Singapore dollar bonds. Named the SGD Credit Rating Grant, the grant will allow both foreign and domestic issuers to offset the associated costs over a five-year period. Qualifying issuers of Singdollar bonds who obtain credit ratings from an international rating agency can claim up to 100% of their credit-rating expenses, subject to a funding cap of SGD 400,000 per issuer. Besides providing greater transparency in the local bond market, this initiative will also enable Singapore bond issuers to attract a broader and more diverse investor base, creating sophistication and growth in the Singapore dollar bond market. (Straits Times)

India launches new economic era with sales tax reform

30 Jun. India introduced the biggest tax reform since its independence. The Goods and Services Tax (GST) will replace federal and state levies, unifying the economy and people into one common market and making it easier to conduct business in India. The GST comes in four rates and numerous exemptions. Services and non-food items will be subjected to higher tax rates, while farming items, such as tractors and fertilizers, will face a lower tax rate. Despite the GST having flaws, HSBC estimates the tax reform could bring about an additional 0.4% growth in India's economy. Companies are estimated to save about USD 14bn from reduced logistics costs and efficiency gains. In addition, companies are incentivized to comply with the GST in order to avail credit for paid taxes, resulting in the widening of the tax net and raising public finances. (Reuters)

Stress tests clear big US banks for USD 100bn payout

29 Jun. All 34 banks passed the second part of the annual stress test. Confident of the healthy financial system, regulators have given the green light for these banks to pay out almost all of their net earnings to their shareholders over the next four quarters. These big banks are set to return between USD 95bn and USD 97bn, which is 50% more than the amount they could pay out last year. (FT)

Bank of England tells lenders to increase capital buffers by GBP 11.4bn (FT)

China-Hong Kong bond link to start Monday to lure inflows (Bloomberg)

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