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Li & Fung weakened by changing global retail landscape

by Dexter Tan

Li & Fung, the world's largest sourcing company by revenue, expects 2016 to be a challenging year for the retail industry. Deflationary pressures and a soft macroeconomic environment are likely to weigh on the firm's trading partners and network of customers. According to the latest annual filing, sales have declined in a number of key geographic segments, including Asia and Europe. Total turnover in FY 2015 decreased 2.4% and earnings dropped 4.6% to USD 421mn. Core operating profit in trading, which accounts for more than 90% of revenue, declined 17.6% from a year ago.

As shown in Figure 1, the RMI-CRI 1-Year Probability of Default (PD) for Li & Fung has been increasing since April 2015. The RMI-CRI 1-year PD climbed from 19bps to more than 48bps in January, exceeding the 23bps median, or RMI-CRI aggregate 1-Year PD for 2023 Hong Kong listed companies. The market capitalization value of Li & Fung, another input to the RMI-CRI PD model, has been on a decline since April 2015. The firm's value reached HKD 67bn a year ago but has since dropped to HKD 38bn. Despite having a relatively high market capitalization value, Li & Fung's default risk continues to remain high in the wake of sluggish consumer demand and low prices.

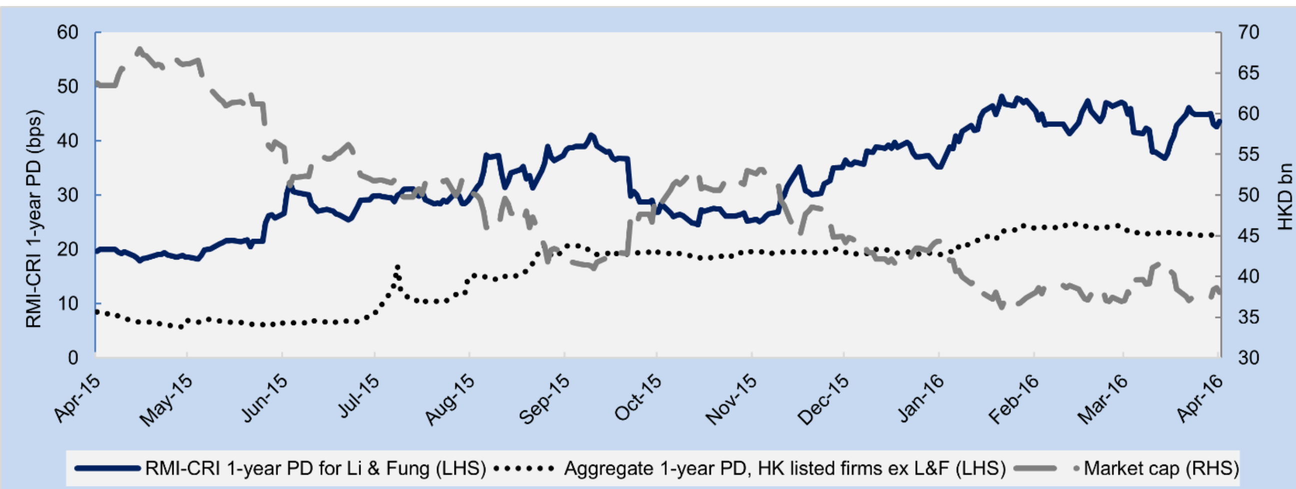

Figure 1. RMI-CRI 1-year PDs vs market cap for Li & Fung. RMI-CRI 1-year PDs were computed using February's calibration. *Source: RMI-CRI, Bloomberg*

The company's low financial liquidity has been hurting its credit profile. Figure 2 displays the cash over total asset ratio (CTA) for Li & Fung. The CTA ratio is a financial liquidity proxy and input to the RMI-CRI model. A low ratio is generally associated with a high default risk. The decline in the CTA was a result of falling retail transactions coupled with poor performance from the firm's recent acquisitions and investments, which have reduced the firm's cash and bank balances.

Figure 2. RMI-CRI adjusted cash to total asset ratio for Li & Fung. *Source: RMI-CRI*

Credit metrics in terms of income statement and balance sheet variables also look dismal. Li & Fung's EBITA margin decreased from 3.95% in Dec 2013 to 2.83% in Dec 2015. Debt to EBITDA, a measure of leverage, increased to 2.41X while its interest coverage ability, the proportion of EBITDA to interest expense, dropped from 7.6X in Dec 2013 to 5.9X in Dec 2015. In addition, 12 month cash flows as a percentage of net debt, plunged from 15.4% to 0.70% in the same period.

As of	EBITA margin	Debt to EBITA (X)	EBITDA to interest expense (X)	12m Cash flow / net debt
Dec 2013	3.95%	2.45	7.60	15.39%
Jun 2014	3.26%	2.12	6.37	4.21%
Dec 2014	3.23%	2.29	6.55	2.21%
Jun 2015	3.25%	2.41	7.14	4.49%
Dec 2015	2.83%	2.41	5.98	0.70%

Table 1. Financial performance for Li & Fung, based on annualized credit ratios. *Source: Bloomberg*

The Li & Fung Group has been struggling to cope with rising labor cost in China and the intense competition from low-cost, fast fashion brands. The company blames changing consumer preferences and buying patterns led by Millennials who are changing the way how consumers make purchase decisions for clothes. The advent of social media is altering consumer behavior, as customers are getting more globally interconnected and are often swayed by mass opinions. Customers are no longer as brand loyal as they used to be. These changing retail trends are impacting the firm's profitability and transforming the manner in which it operates.

Credit News

Subprime housing risks raise red flags in China

Apr 4. Although the Chinese government has put in a lot of effort to tackle a glut of vacant housing in China by spurring home lending, it seemed to have triggered a bigger problem – a surge in risky subprime-style loans. A rapid rise in home buyers borrowing for their down payments has raised concerns that the easy credit could crater the housing market and spark a financial crisis similar to the one that what happened in the US in 2008. In addition, peer-to-peer lenders, who raise money from investors and then lend it out at higher interest rates, made USD 143mn in down payment loans in January 2016, more than three times the amount in July 2015. The overheated borrowing has made officials step on the brakes. The central bank and the housing ministry last month started to crack down on the down payment home loans. (WSJ)

China rating outlook cut to negative from stable by S&P

Mar 31. Standard & Poor's (S&P) has cut the outlook for China's credit rating to negative from stable, saying the nation's economic rebalancing is likely to proceed more slowly than the ratings firm had expected. The nation's credit rating is AA- with a negative outlook. According to S&P, a downgrade could follow if S&P sees a higher likelihood that China seeks to stabilize growth at or above 6.5% by increasing credit at a "significant faster rate" than nominal GDP growth. Rating could stabilize if credit growth is moderated to levels in line with economic expansion. (Bloomberg)

Moody's revises outlook of Singapore banks to negative

Mar 31. Moody's Investor Service has lowered the outlook on Singapore's largest banks, DBS Group, Oversea-Chinese Banking Corp and United Overseas Bank, to negative from stable. Moody's rating reflects its expectation that a more challenging operating environment for banks in Singapore this year, and possibly beyond, will put pressure on the banks' asset quality and profitability. However, the agency noted that Singapore banks maintain "very strong buffers" in terms of capital, loan loss provisions and pre-provision income. The lenders' funding and liquidity profiles are also robust and there was a "very high" probability of government support, if needed. (Channel NewsAsia)

Molycorp wins approval to exit Chapter 11 bankruptcy

Mar 30. Molycorp bondholders have won court approval to buy mineral rights and intellectual property associated with the company's Mountain Pass mine in California, under a plan that will allow the company to exit Chapter 11 bankruptcy. The plan, which excludes the mine itself, will put a trimmed-down Molycorp largely in the hands of senior lender Oaktree Capital Management while unsecured creditors share a minority stake in the company. (WSJ)

Spain's Abengoa files for Chapter 15 bankruptcy in US

Mar 29. Abengoa SA has filed for bankruptcy protection in the US as the Spanish energy company continues talks with its banks and bondholders to agree on its plan to restructure billions of dollars in debt. Abengoa is one of the world's top builders of power lines transporting energy across Latin America and a top engineering and construction business, making large renewable-energy power plants in places ranging from Kansas to the UK. The firm's financial woes trace back to Spain's boom years, when the company began to build such projects for itself, fueled by cheaper bank loans and a desire to expand. The firm took on billions of dollars of debt in anticipation of a growth rate that did not materialize. (WSJ)

Lagarde dismisses claim that Greece is being pushed to default (FT)

Spain deficit fight suffers setback (FT)

Japan's industrial output falls as weak exports sap demand (Bloomberg)

Regulatory Updates

Basel said to weigh change that could ease derivatives capital

Apr 1. The Basel Committee on Banking Supervision is expected to allow further nettings in the calculation of derivatives exposure. Concurrently, the Tier 1 capital requirement could be increased for the 30 largest banks considered systemically important. The impact from both changes is expected to be neutral for most European banks, since the lower derivatives exposure would be offset by higher capital requirements. US banks, which are already subjected to the higher US capital requirements, would see a boost in their risk capital ratios. (Bloomberg)

Fed rule allows banks to use munis as part of crisis buffer

Apr 1. The Federal Reserve has given the final approval to let banks include certain investment-grade municipal bonds in meeting liquidity requirements. Qualified municipal bonds can be part of a second tier of liquid assets, which can total no more than 40% of overall liquidity. The decision, however, only provides partial easing to banks' needs of liquid assets, as the Office of the Comptroller of the Currency (OCC) has large oversight over banks' activities in the municipal bond market. So far, the OCC has yet to issue similar guidance on the matter. (Bloomberg)

Moody's fined USD 1.4mn as Hong Kong tribunal sides with SFC

Mar 31. Moody's Investors Service must pay an HKD 11mn (USD 1.4mn) penalty after a Hong Kong tribunal upheld an action against the firm by the city's financial regulator. The Securities and Futures Appeals Tribunal on Thursday ruled that Moody's was acting as a regulated entity providing credit-rating services when it published a report about 61 Chinese companies in 2011. That meant Moody's had to abide by the Securities and Futures Commission's code of conduct, which the regulator said the report breached by failing to provide sufficient explanations for its judgments, and not ensuring the accuracy of its claims. (Bloomberg)

EU lowers insurers' capital requirements to spur infrastructure investments standard (Insurance Journal)

Global regulators move closer to regulating fintech (Reuters)

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