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Weekly Credit Brief May 28 - Jun 3 2019

# Tesla's worsening credit outlook in the midst of challenges

By Glendon Gwee

Tesla Inc has been grabbing the headlines with the recent 40% plunge of its market capitalization year to date. This plunge can be attributed to the recent earnings quarter where Tesla reported a loss of USD 700mn mainly due to a decrease in revenue caused by supply chain issues. At the same time, there was a reduction of USD 1.5bn of cash mainly due to its repayment of a USD 920mn convertible bond. This reduced Tesla's cash balance from USD 3.7bn to USD 2.2bn and the company's long-term debt/equity ratio increased from 148.94% in Q4 2018 to 173.98% in the most recent quarter. The numbers shows that Tesla is highly leveraged and its credit outlook is weakening. This is further supported by the NUS-CRI Probability of Default (PD). The NUS-CRI 1-year PD of Tesla reached the highest level since 2018 June at 76.7bps. Tesla's PD more than doubled from March 2019 to May 2019.

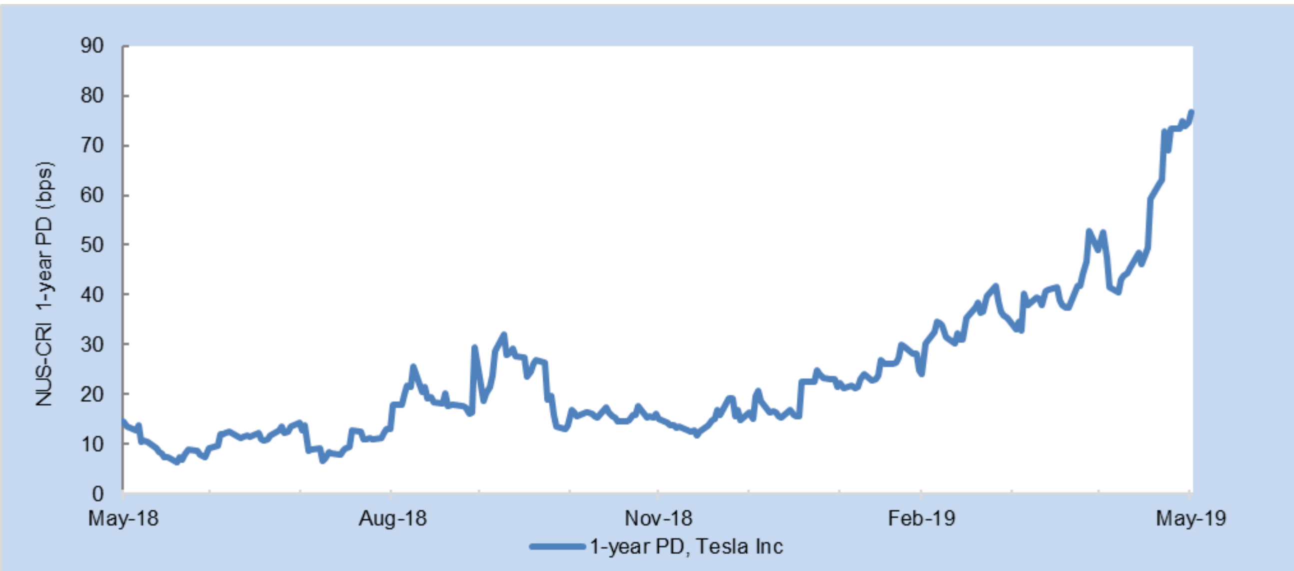


Figure 1: NUS-CRI 1-year PD for Tesla Inc. *Source: NUS-CRI*

The company has recently been plagued with demand and supply chain issues which have contributed to the worsening of Tesla's credit outlook. Demand for Tesla vehicles have been stagnating as the price of a Tesla is not competitive enough. Demand for Tesla vehicles dropped from 43,900 in the Nov-Dec 2018 to 12,250 in Jan –Feb 2019. Aside from stagnating demand, Tesla has also been plagued by supply chain issues. Tesla managed to produce 63,000 vehicles in Q1 2019 however it was only able to deliver 51,000 units of model 3 vehicles due to logistical and shipping delays. Tesla has to iron out such supply chain issues as it greatly affects its ability to increase revenue. By delaying deliveries, Tesla will have to incur unnecessary costs such as inventory and extra manpower costs as well.

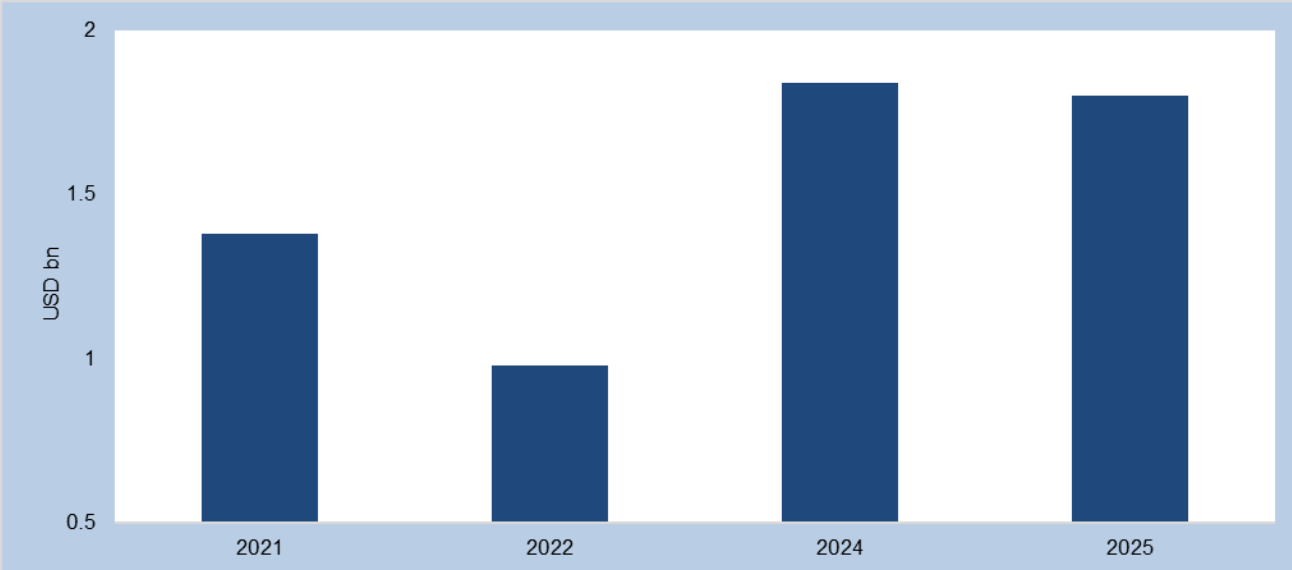


Figure 2: Tesla's bonds maturity schedule. *Source: Bloomberg*

The recent poor earnings performance has also affected the pricing of its bonds. As shown above, Tesla's 5.3% bonds due in 2025 and at an issue price of USD 100, has been trading at USD 81.88 as at 28 May 2019. The decline in the price of the bonds can be attributed to the recent financial performance shown by Tesla in the recent quarters. This shows that confidence in Tesla's ability to repay the bond is decreasing. Tesla recently did a debt and stock offering in May 2019 which boosted its balance sheet by USD 2.59bn comprising of USD 750mn common stock and USD 1.84bn from convertible bonds. This offering is positive news for Tesla's credit profile as it helps boosts its cash balance. This enhanced cash balance can be used to help in the expansion of model 3 production and also cushion any weaker demand in the near future. The capital raise from the offering could also be used to service the bonds that will be due in 2021 and 2022.

US-China trade tensions remain a key concern for Tesla. However, it is not all gloomy for Tesla. Tesla's Gigafactory Shanghai is expected to finish construction by May 2019 and is estimated to be operational by September 2019. It is expected to help boost Model 3 production and also bring down production cost to at least 50% per unit of capacity. This would allow the company to price the model 3 at a more affordable price and will most probably attract more demand thus helping to improve profitability and cash flows of the company.

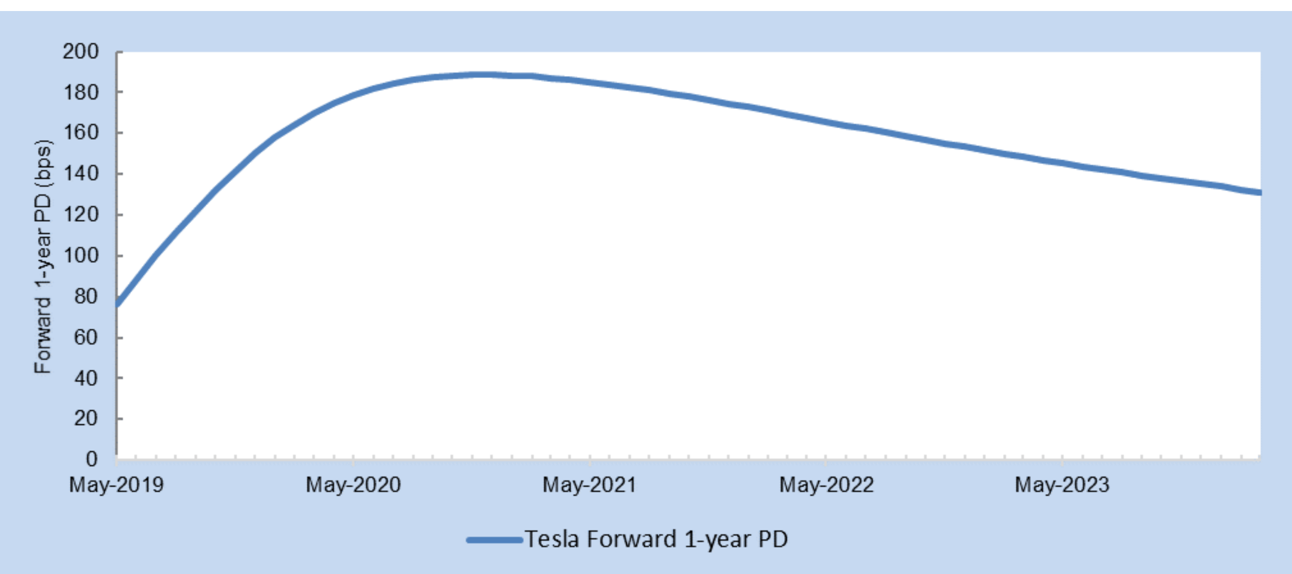


Figure 3: NUS-CRI Forward 1-year PD for Tesla Inc. *Source: NUS-CRI*

The NUS-CRI Forward 1-Year PD shows that the credit profile of Tesla will worsen within the next 3 years based on information available on 31 May 2019. The Forward PD calculates the conditional credit risk a company faces in the future. Tesla's near-term credit outlook remains dim and the recent offering, which will only be due in 2024, may be the only lifeline it has to keep the engine from sputtering. However, with the future expansion plans in the pipeline, it could be the very boost Tesla needs to keep its engine going to achieve profitability and improve its credit profile.

## Credit News

### Japan's first junk bond sale offers yield of less than 1%

**May 31.** Aiful, a Kyoto-based consumer lender that was forced to suspend operations due to accusations off strong-arm collection tactics more than 10 years ago, issued Japan's first publicly-offered junk bond on May 31 2019. The speculative-grade notes that matures in December 2012 and was rated BB by Japan Credit Rating Agency offers an interest rate of 0.99% - the lowest coupon for any fixed-rate junk bonds in the world, according to Bloomberg data. The wafer-thin interest rate is, however, still a more appealing alternative to the 10-year Japanese government bond whose yield slipped to -0.1% for the first time since August 2016. The coupon highlights the country's institutional desperation for yield amid the Bank of Japan's negative interest rate policy. (FT)

### Investors beat a retreat from US junk bonds

**May 31.** Rising pessimism among investors has led to the fourth week of net withdrawals from US junk bond funds in a row: growing uncertainties about a possible recession, amplified by the US-China trade war, have led funds investing in the US high-yield market to lose USD 6.5bn in May, according to EPFR Global. While junk bond yields remain below their levels during last December's market turmoil, their average spread above treasuries has widened by 68bps to 4.5% in May, indicating investors' expectations of growing risk of bond defaults in the high-yield market. (FT)

### Bond bears dust off debt insurance on wave of corporate pain

**May 30.** Corporate debt insurance is becoming popular as a result of the rising default rates and series of high-profile failures are paying off for short sellers. Credit-default swaps trading increased by 7% and the payouts on contracts have boosted the value of some of these derivatives. The cost of insuring distressed companies have increased with swaps on some of Europe's riskiest names reaching thousands of basis points compared to about 300bps for the region's high yield benchmark. Defaults are still quite low but swaps are starting to be more relevant especially for funds. (Bloomberg)

### Morningstar takes aim at rating giants with USD 669mn DBRS deal

**May 29.** Chicago-based Morningstar will pay USD 669mn for DBRS, the fourth largest credit rating agency, as it attempts to dislodge the big three credit rating agencies, S&P Global, Moody's and Fitch. After the acquisition, Morningstar's market share of the credit-rating market will rise from 0.1% to 2.4%. However, there are concerns about its decision as Morningstar's brand recognition in mutual funds has so far failed to carry over into credit ratings. Credit rating agencies were in the spotlight after the financial crisis as critics complained that their ratings were inflated on mortgage-back securities in order to win business. In 2015, S&P paid USD 1.4bn to settle claims over its role in the run-up to the crisis while Moody's paid USD 864mn. (FT)

### Investors want Latin America debt. Companies aren't selling

**May 29.** High liquidity in capital markets has failed to impress Latin American companies, with issuance of new debt at its lowest level since the financial crisis over a decade ago. Despite investors agreeing to record low yields in exchange for their money, companies are hesitant to raise new debt as the economy slows down. At the end of 2018, the average net-debt-to-EBITDA ratio in Latin America dropped to 1.93, its lowest level since 2012, after having exceeded a level of 4 in 2016. Lower rated bonds on the other hand have boomed so far in 2019, due to the high demand for investment opportunities. (Bloomberg)

**Investors lap up Italian debt despite European Commission warning** (FT)

**Portugal raises RMB 2bn from 'Panda bond' sale** (FT)

**Singapore housing loans shrink again, with overall lending flat in April: MAS data** (Business Times)

**Regulatory Updates**

**ECB seen offering generous loans to banks to boost feeble growth**

**May 30.** The European Central bank (ECB) is expected to offer euro-area banks generous terms on its upcoming long term loans, with the interest rate on the two-year loans to be below the ECB's benchmark rate. The policy makers will be reviewing the updated economic forecasts for the second half of this year before the ECB President unveils the details of the bank loans. The ECB will probably stick to the view to keep interest rates at record lows given that the recovery of the economy is expected to be delayed. (Bloomberg)

**After Baoshang rescue, China central bank pours cash into banking system**

**May 29.** Following the People's Bank of China's (PBOC) takeover of Baoshang Bank on May 24 2019, there are growing worries about the wider problems plaguing China's regional banks, driving up short-term interest rates. In response, the PBOC injected a net CNY 400bn in the following week to keep banking system liquidity "reasonably ample". The PBOC is also likely to further step up its easing either through open market operations or cutting of banks' reserve requirement ratio given the huge amounts of maturing medium-term lending facility and negotiable certificates of deposits in the next three months. The injection managed to lower the seven-day repo – considered the best indicator of general liquidity in China – from 3.54% on May 28 to 2.81% on May 27; yet swap curve moved upward and some market analysts were concerned about hurting the already weakening yuan. (Reuters)

**New Zealand central bank says risks remain elevated, LVR appropriate for now** (Business Times)

**India's central bank faces calls for rate cuts, liquidity boost** (Business Times)

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Contributing Editor: Liu Hanlei