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Risks remain in General Electric's credit outlook amidst spin-off plans

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- **The NUS-CRI 1-year PD shows the improved credit profile of GE since its initial deterioration due to the COVID-19 pandemic, driven by recovering operations and deleveraging efforts**
- **The NUS-CRI Forward 1-year PD for GE as of Nov-2021 is set to converge to similar levels seen in the past due to diversification risks from the proposed business restructuring**

General Electric Co. (GE) announced on Nov 9 its plan to split the conglomerate into two other public companies[1]. The proposed spin-offs will specialize in GE's core revenue drivers, namely healthcare and energy, while the current GE will be focusing solely on the existing conglomerate's aviation business. The firm, especially its aviation segment, was hit hard by the fallout of the pandemic but has since recovered in terms of operating margins, while simultaneously reducing debt load through the sale of assets and cost-cutting measures. The NUS-CRI 1-year Probability of Default (PD) demonstrates the significant improvement of GE's credit health since late 2020, with the company's PD dipping below the BBB upper bound in May-2021 when referenced to PDiR2.0[2] bounds (See Figure 1a). However, the long-term credit outlook for GE is set to converge to levels witnessed in the past, especially due to the potential loss of diversification benefits currently experienced by the conglomerate. As such, the NUS-CRI Forward 1-year PD (Forward PD[3]) as of Nov-2021 trends upwards, converging to similar levels seen in May-2020 and Jan-2021 (See Figure 1b).

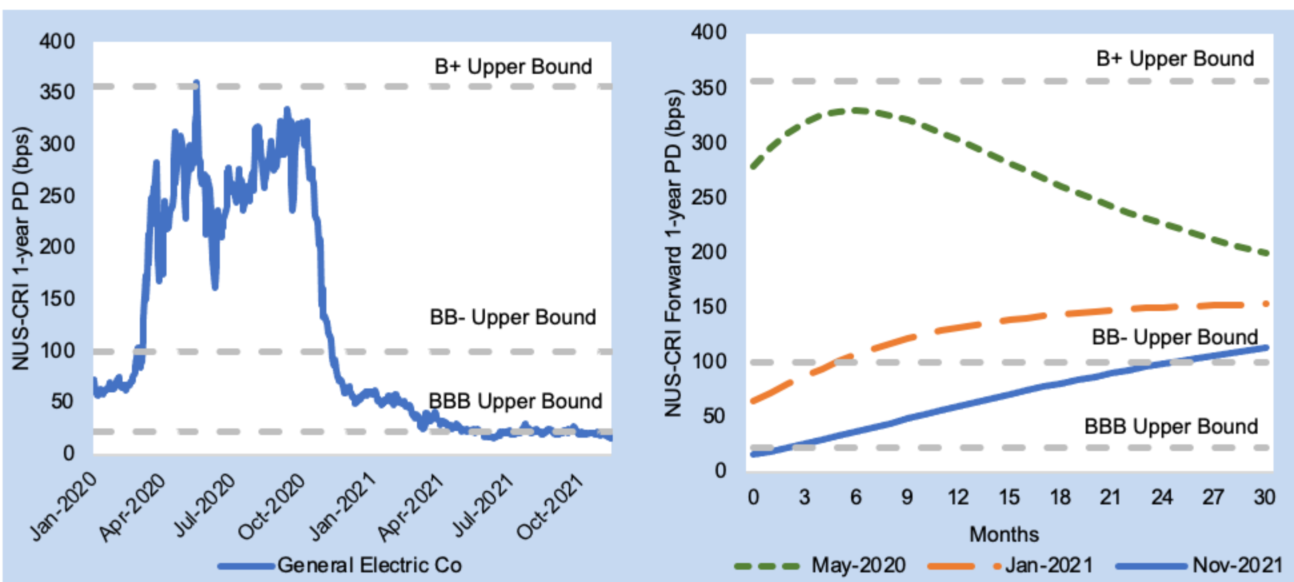

Figure 1a (LHS): NUS-CRI 1-year PD for General Electric Co. from Jan-2020 to Nov-2021 with reference to PDiR2.0 bounds. Figure 1b (RHS): NUS-CRI Forward 1-year PD for General Electric Co. as of May-2020, Jan-2021, and Nov-2021. *Source: NUS-CRI*

The pandemic caused massive disruptions to the firm's operations, particularly in the jet engine manufacturing business, GE's leading revenue driver, as planes were grounded and new jet purchases were canceled. In Q2 2020, the company reported a loss of USD 2.18bn due to poor sales in most of its business segments. However,

[1] The first company will be a spin-off of GE Healthcare in early 2023; the second company will be an energy company combining GE Renewable Energy, GE Power, and GE Digital in early 2024; and finally, the current GE will focus on the existing GE Aviation while retaining a 19.9% stake in GE Healthcare.

[2] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

[3] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months, conditional on the firm's survival in the next 6 months. The Forward PD is only displayed for the next 30 months given that GE's business and credit profile may change after the restructuring process concludes in early 2024.

concurrent with the reopening of economies and the resultant recovery in the demand for air travel, operating margins have since improved as shown in Figure 2a. Since the end of last year, the company has also managed to significantly lower its total debt to capital while keeping liquidity relatively stable. This improvement can be reflected in the steep decline in PD levels in Figure 1a since the end of Q4 2020. Looking forward, GE's aviation unit is projected to operate with margins of up to 20%, especially as air travel is expected to recover to pre-pandemic levels in 2023 and the global air fleet is projected to grow with an annual CAGR of 3.4% up to 2030, boding well for the company's financial health.

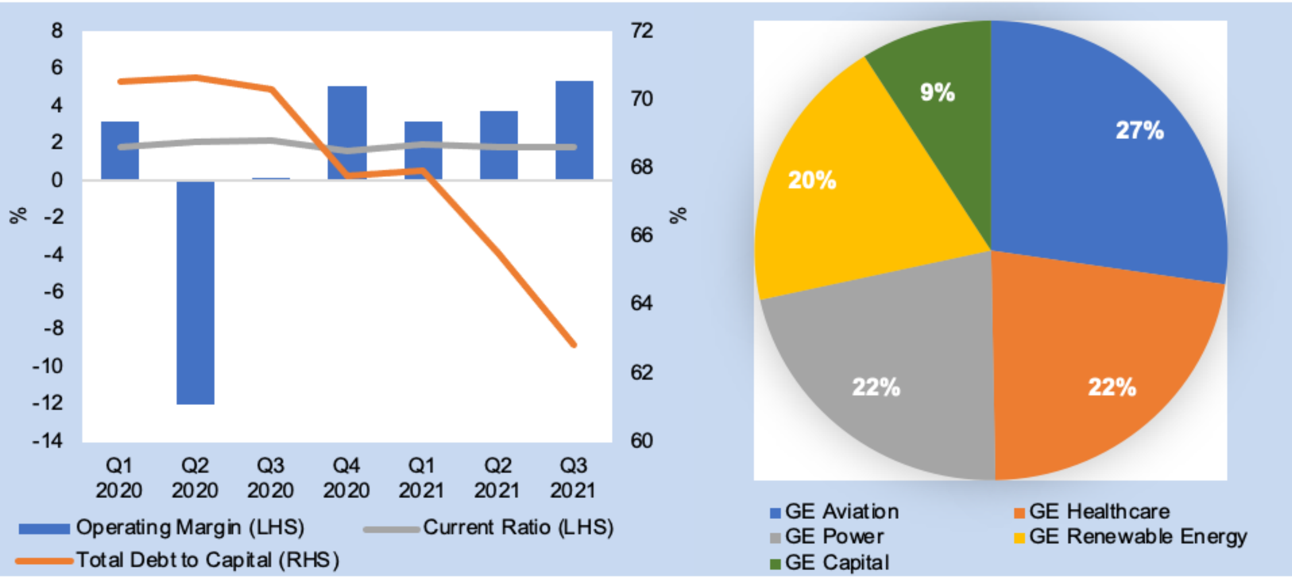

Figure 2a (LHS): Operating Margin and Current Ratio on the primary axis and Total Debt to Capital on the secondary axis for General Electric Co. from Q1 2020 to Q3 2021. Figure 2b (RHS): General Electric Co. revenue breakdown by segment for FY2020. *Source: Bloomberg, Statista*

After the 2008 financial crisis, GE had become one of the most heavily indebted companies in the US. However, under its most recent management, since Sep-2018, GE has made strides in reducing its debt burden, mainly by selling assets to slim down its diversified business lines. In Mar-2021, GE announced the sale of its aircraft-leasing business[4] for over USD 24bn in cash, effectively dissolving GE Capital in the process and using the proceeds to reduce the company's debt load. Additionally, GE recently announced a tender offer to buy back USD 23bn of its bonds, mainly those maturing in 2022 and 2023. Since 2018, GE has managed to cut down on over 50% of its outstanding debt to USD 65.8bn at the end of Q3 2021 while steadily improving its interest coverage ratio from 2.27 in Q3 2018 to 3.7 in Q3 2021, and is on track to reduce its debt burden to USD 45bn by 2023. The shrinking debt load will help strengthen GE's balance sheet and boost debt servicing capabilities.

According to GE, the main goal of the proposed restructuring is to further deepen operational focus and offer greater strategic flexibility from a decentralized business model for each of its three core businesses (See Figure 2b). Following the announcement, its share price jumped by more than 10% in pre-market trading, indicating that this move was well-received as investors could easily choose which business segment they want to back once the restructuring is completed. Furthermore, credit default swaps on the company's 5-year bonds dropped to their lowest price levels in over three years, implying that investors perceive less default risk for owning GE's long-term debts. The reduced risk may boost investors' confidence in the company and lower its borrowing costs should it need to raise more capital in the future.

A prominent risk that could arise from the restructure would be the loss of diversification benefits from GE's various business segments. For instance, profits from the more resilient and better-performing healthcare unit helped dampen the losses suffered by its aviation business during the pandemic. Should the company face difficulties in the future, the three separate entities created due to the restructuring process will be more susceptible to shocks, and thus may have to depend on external financing to support their operations. This risk could be a driver of the elevating Forward PD as of Nov-2021 (See Figure 1b).

On the other hand, the restructuring could potentially resolve a long-standing structural risk present in GE's diverse business model, which arises when distressed units threaten to drag down robust business segments. For example, GE Capital incurred massive losses during the 2008 financial crisis and consequently saddled the company with over USD 50bn of debt. Furthermore, given that GE is still planning on holding a stake in its

[4] GE Capital Aviation Services (GECAS) is the largest asset of GE Capital, the company's finance unit.

healthcare spin-off, which accounts for 63% of the company's profits as of Q2 2021, the company may still benefit from a series of acquisitions that the healthcare unit has conducted to further expand its services in the medical field, potentially improving cash flows due to recovering demand for non-COVID-19 related procedures.

GE's restructuring plans are not a first for the industry, where previously peers such as Siemens, and most recently Toshiba and Johnson & Johnson have executed or planned their own spin-offs. This trend could be a testament that conglomerate models may not be as operationally efficient in the current market as they were in the past. Looking forward, the credit outlook for GE may be subject to changes once it has completed its spin-off to three different entities, but at present, with debt reduction still the top priority for GE, the firm seems better positioned to navigate through the proposed restructuring.

Credit News

Bond ructions intensify risk of 'downward spiral' for Chinese property groups

Nov 11. A selling wave in junk bonds issued by riskier Chinese property developers pushed borrowing costs to the highest level in a decade, jeopardizing companies' ability to access a key funding source. Concerns over a succession of delayed bond payments by prominent real estate developers are causing jitters in the market for the dollar-denominated debt of Chinese corporations with a speculative-grade credit rating. The sector is experiencing excessive borrowing costs at a time when they need cash to avoid defaulting on their loans due to a slump in the Chinese property market and pressure from Beijing to decrease indebtedness. The average yield on an index of Chinese high-yield dollar bonds increased to over 29% this week, pushing borrowing costs to its highest level since the global financial crisis. (FT)

Investors await Evergrande's overdue USD 148mn payment as debt woes grow

Nov 10. Evergrande faced a deadline on Wednesday for a USD 148bn offshore bond payment. With USD 300bn in liabilities, it has been floundering from deadline to deadline in recent weeks. Concerns over Evergrande's potential fallout have also roiled China's property sector, as the bonds of real estate companies plunged. Some real estate companies plan to issue debt in the inter-bank market, highlighting the liquidity squeeze. Debt-laden developers including Evergrande and peer Kaisa Group have been trying to sell off some of their property and other company assets to raise cash. To control the risk, Beijing has been urging state-owned companies and state-backed property developers to purchase some of Evergrande's assets. On Wednesday, the spread between investment-grade Chinese firms and US Treasuries increased to a more than five-month high, indicating rising concerns about the developers' woes spreading to safer firms as well. (Nikkei)

Cracks appear in world's biggest bond market as Fed pulls back

Nov 14. Warning signs are starting to emerge as the Federal Reserve begins to taper its USD 80bn a month purchases. Triggered by a report on surging inflation, the yield on two-year Treasury notes rose nearly ten basis points on Wednesday, marking its largest move since March 2020. The Fed also plans to scale back its monthly USD 10bn purchases of treasuries. Against this backdrop, the Treasury Department plans to hold its monthly auction of USD 20bn bonds, which would test the markets' ability to function smoothly as the Fed withdraws support. Any deviation in the pricing of treasuries has wide implications as their yields are used to value more than USD 50tn assets globally. The volatility in the Treasury markets reflects uncertainty regarding government and monetary policies as inflation concerns surge. (Bloomberg)

Chinese junk bond yields top 25% as property-market strains intensify

Nov 9. The biggest selloff in China's international junk-bond market has wiped out about a third of bondholders' wealth over the past six months. Regulatory curbs on borrowing, extreme dislocation in credit markets, and slowing home sales are pressuring financing opportunities for Chinese property developers, which account for most of China's high-yield issuance. The confidence crisis around China Evergrande Group has spread to numerous real-estate firms, which now face a much higher risk of reneging on their debt. The market endured another wave of selling late last week and on Monday, as investors even dumped bonds issued by financially stronger developers. The yield on an ICE BofA index of Chinese junk bonds topped 25% for the first time since Mar 2009 on Friday and rose further to 26.6% on Monday. The surging yields imply very high default risks, adding to developers' problems by making refinancing through issuing new debt hard or almost impossible. (WSJ)

China offers USD 4.6bn in Euro bonds

Nov 9. China started selling Euro-denominated government bonds, with a total expected value of EUR 4bn. It has only been weeks since it raised USD 4bn in dollar debt at low rates with strong international demand, despite slowing economic growth. China's Ministry of Finance is offering bonds with maturities of three, seven, and 12 years. The three- and seven-year bond's initial price guidance is around 0.2 percentage points and 0.4 percentage points over mid-swaps respectively. The 12-year bond is being offered at 0.65 percentage points high than mid-swaps. This will be the third consecutive year that China has issued bonds in both US dollars and euros in the fall. Twelve banks, including Chinese, US, and European institutions, are in charge of the euro bond sale according to the Ministry of Finance. (WSJ)

Lufthansa returns to bond market as travel bookings pick up (Bloomberg)

China real estate firms may issue inter-bank market debt (Reuters)

About USD 35bn of top-rated bonds expected ahead of holidays (Bloomberg)

Regulatory Updates

Sunak puts 'growth' at heart of post-Brexit financial regulation

Nov 10. UK Chancellor Rishi Sunak revealed additional details on Britain's proposed financial regulation after Brexit indicating that "growth and competitiveness" will be important factors in regulatory oversight. The proposals aim to provide more flexible policies, which would support an increase in the long-term growth rate of the UK economy. Officials also understand that long-term growth may be achieved by making the UK internationally competitive. The UK is trying to navigate a precarious situation while attempting to recreate EU financial rules at a national level. The aim is to make UK attractive internationally while staying away from the regulation which would push firms to take on higher risks. (FT)

Kashkari warns fed overreaction to inflation could be harmful

Nov 15. Federal Reserve Bank of Minneapolis President Neel Kashkari said the US central bank should not overreact to elevated inflation, because it is likely to prove temporary. The consumer price index rose 6.2% in the 12 months through October, the fastest annual pace since 1990, increasing the pressure on the Fed to accelerate its withdrawal of support for the economy. Fed policymakers announced on Nov 3 they had agreed to begin reducing monthly bond purchases designed to boost the economy by suppressing borrowing costs. They left their benchmark interest rate in a range between zero and 0.25%. Kashkari said the move was "appropriate" but stressed that moving too quickly to remove support could end up hurting the economy more in the long term than it helps on the inflation front, due to monetary policy lags. (Bloomberg)

Marathon sells first new-issue CLO with tranche linked to SOFR (Bloomberg)

Bank of Israel plans to increase competition in mortgage market (Bloomberg)

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