



Dark clouds loom over Vale

by [Samuel LIM Kok Hong](#)

The iron ore industry has continued to witness a decline in prices since the start of 2014; the trend is driven by a supply glut and a slowdown in the global economy, notably in emerging markets, making iron ore one of the worst-performing commodities in recent years. As of October 2015, global steel production had declined YoY for the twelfth consecutive month. China, the biggest producer of steel, had also experienced a decline in steel output by 3.1% YoY in October 2015. As iron is a key component of steel, there would be sustained downward pressures on price. However, some top iron ore producers, such as Vale SA (Vale), Rio Tinto and BHP, have been pumping more supplies into the market amid the low price environment, aiming to [squeeze out](#) smaller players. Vale, Rio Tinto, and BHP [all reported](#) increases in quarterly supply in the latest reports. Nonetheless, the move is adding some pressure on these big players, especially the pure play – Vale.

Vale is the biggest iron ore producer in the world in terms of revenue, boasting industry revenue of USD 25.64bn in 2014. The company is a Brazilian multinational metals and mining corporation, with around 70% of its revenue derived from iron ores. In comparison, iron ore accounts for 47% of BHP's revenue and 39.3% of Rio Tinto's. On Nov 5, two dams burst at Samarco's mine; Samarco SA is a Brazilian company jointly owned by Vale. A deadly mudslide ensued, ravaging the nearby towns and causing the death of 9 people. Vale was charged a preliminary fine and could face more fines from environmental regulators for pollution and damage brought about to the surrounding areas. There have also been ongoing concerns regarding the [possible permanent suspension](#) of Samarco's operations in that area, which could be the coup de grâce to the firm. Just last week, Moody downgraded Samarco's rating from [Baa3 to Ba1](#), citing the material impact of the accident on the company's operations as the main reason. This would in turn adversely affect Vale. The market capitalization of Vale has fallen from BRL 119bn on May 4, 2015 to BRL 74bn on Nov 12, 2015. Its RMI-CRI 1-year Probability of Default (PD) has surged from 41.49bps on May 4, 2015 to 180.67bps on Nov 12, 2015, highlighting the deteriorating credit rating of the company.

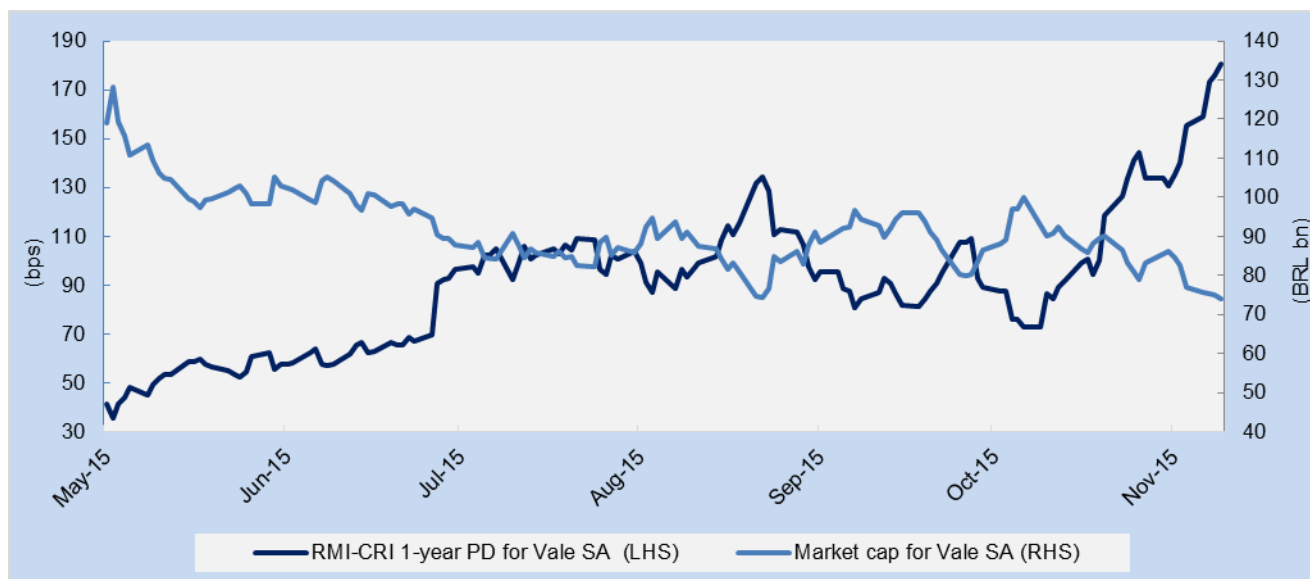


Figure 1. RMI-CRI 1-year PD and market cap for Vale SA. Source: RMI-CRI, Bloomberg

As shown in Table 1, revenue figures of Vale indicate diminishing profitability of the firm over the recent years. Pretax income, returns on equity and assets were positive in Q3 2013. These metrics, however, were negative in Q3 2014 and continued to worsen in Q3 2015. However, BHP and Rio Tinto, two of the largest iron-ore producers, were able to maintain positive returns on equity and asset over the same time period.

3 Months Ending	Q3 2013	Q3 2014	Q3 2015
Pretax Income (BRL mn)	9,913	-4,100	-24,166
Return on Equity (%)	6.11	-6.09	-9.88
Return on Assets (%)	3.38	-3.09	-4.56
Total Debt / Equity (%)	45.34	46.20	64.44
Quick Ratio	1.15	1.08	0.63
EBIT / Interest Expense	15.40	15.45	3.44

Table 1. Financial figures for Vale SA. Source: Bloomberg

Leverage figures of the firm are not looking too rosy compared to previous years as well as in comparison to its peers'. Vale's debt to equity ratio has risen over the years. BHP and Rio Tinto have debt to equity ratios at lower levels than Vale in their latest financial statement data. Liquidity ratios have been on a decline over the years. As indicated above, quick ratio has dropped from 1.15 to 0.63 over the last two years. BHP and Rio Tinto have higher quick ratio than Vale. The interest coverage ratio has also declined over the two years and it is also much lower than both of its peers'.

Vale has been hit by the perfect storm of a mining disaster, falling iron ore prices and China fears. Vale's financial health, although it has worsened, still remains sound as it has been generating positive cash flow from its operations this year despite the economic troubles, and it was still able to give out dividends this year. Therefore, it would take more headwinds before the creditors of Vale to even entertain the very notion of a default.

Credit News

Chinese bond defaults signal moment of truth for ratings agencies, banks

Nov 16. China Shanshui Cement's CNY 2bn default on Nov 12 shows that Chinese investors may have misallocated large sums of capital to many inefficient companies, such as state owned dinosaurs and opaque local government financing vehicles. China's policymakers could allow more inefficient companies to fail, which could trigger a crisis for the bondholders – most of which are China's banks, or allow the misallocations to continue, which could result in China's industrial overcapacity and economic stagnation. However, not all market observers say the defaults are bad for the market. Mr. Phillip Li, managing director at China Chengxin Asia Pacific Credit Ratings, said that the recent defaults were necessary in order for the debt market to be normal. ([Today](#))

Bank of Japan to boost its balance sheet buffer, with eye on QE exit

Nov 13. The Bank of Japan plans to increase the amount of reserves used to offset potential losses from its stimulus program. Since April 2013, the central bank has been purchasing JPY 80tn of government bonds every year with an intention to reach an inflation target of 2 percent. However, government bond prices have been dropping which could result in losses for the central bank once it tapers its bond purchases. ([Reuters](#))

ECB quantitative easing losing its power to pack a punch in markets

Nov 13. Earlier this year, when the ECB made clear it would launch a quantitative-easing program, Eurozone bonds of all stripes went on a strong rally. Now, even though ECB President Mario Draghi has indicated that more stimulus is coming, the reaction has been less sweeping. The phenomenon reflected two things: investors are increasingly confident that the region's economy will continue its slow, steady recovery. But it also indicates that the ECB's bond-buying program, known as quantitative easing or QE, is losing its power to pack a punch in the markets. According to a portfolio manager at BlueBay Asset Management, investors got burned quite badly in the volatility earlier this year. As a result, they are less inclined to chase yields lower. ([WSJ](#))

Brazil's mining disaster has Samarco creditors bracing for worst

Nov 11. Brazil's deadly mining disaster has investors question whether Samarco Mineracao SA can withstand the fallout. Two dams at the iron-ore producer's biggest operation burst five days ago, unleashing a torrent of muddy floodwater that killed at least three people and left 25 others missing, as of Nov 11. The site is now indefinitely closed. Deutsche Bank AG estimates that the cleanup costs may exceed USD 1bn. The company's USD 2.2bn notes have lost approximately a third of their value since Nov 5, 2015. Creditors are concerned that a temporary suspension of Samarco's license to operate in the area may become permanent, which can make a huge financial impact. ([Bloomberg](#))

Malaysia has very low political risk despite 1MDB ([TODAY](#))

Fitch ratings hints Ukraine bankruptcy close as Kyiv defaults ([Forbes](#))

Energy default alarms get louder as pain seen lasting into 2016 ([Bloomberg](#))

Regulatory Updates**End of 'Too-Big-to-Fail' banking era endorsed by world leaders**

Nov 15. World leaders are planning to endorse proposals by regulators to end the era of too-big-to-fail banks, and backed proposals to wrap up sweeping reforms of rules for the global banking system. The proposals, which force bond investors to take losses if banks fail, are due to come into effect in two steps starting in 2019. If the rules are approved, the world's thirty largest banks will have to commit outstanding liabilities and instruments "readily available for bail in" equivalent to the minimum of 16% of risk-weighted assets in 2019, rising to 18% in 2022. ([Bloomberg](#))

21 G-SIBS sign ISDA Resolution Stay Protocol

Nov 12. 21 banks have signed the revised ISDA Universal Resolution Stay Protocol which was jointly developed by the Financial Stability Board and the International Swaps and Derivatives Association Inc. The revised framework replaces the original Protocol which was voluntarily signed by 18 banks in November 2014. The new Protocol covers a broader universe of financial contracts and reduces the risk that a bank resolution will trigger a chaotic unwinding of contracts in the banking system. The new regime also gives resolution authorities greater power to affect a resolution such as the imposition of a temporary stay on counterparties' early termination rights in the event of a bank failure. ([ISDA](#))

EBA consults on draft guidelines on the treatment of CVA risk under SREP

Nov 12. The European Banking Authority is recommending a coordinated European approach for the annual monitoring of Credit Value Adjustment (CVA) risk within various jurisdictions. Under Article 456(2) of Regulation (EU) No 575/2013, the EBA has been tasked to monitor the fund requirements for CVA risk and is responsible for the treatment and calculation of the risk charge. The new guidelines propose a new framework to 1) determine the materiality of CVA risk; 2) the SREP (Supervisory Review and Evaluation Process) assessment of material CVA risk and its management, measurement and control; 3) SREP assessment of adequacy of funds to cover the CVA risk and 4) the calculation of additional funds required to cover for such risk. ([EBA](#))

G-20 says inequality causes instability as it urges tax action ([Bloomberg](#))

ECB finds USD 1.87bn capital gap in stress test of nine banks ([Bloomberg](#))

MAS finalizing rules on retail bonds from corporates ([Straits Times](#))