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Muted demand for wind turbines clouds the future of Siemens Gamesa

by LU Chang

Corrections: The paragraph describing the Forward Probability of Default has been revised as the interpretation of Figure 1 was incorrectly stated. The references to the firm's default risk over the next 27 months have been removed, sections in italics below highlight changes made to the original article.

In April 2017, the second and fourth largest offshore wind turbine producers in the world, Siemens Wind Power and Gamesa Corporación Tecnológica, merged to form Siemens Gamesa Renewable Energy (SGRE). The merger was intended at cost cutting and facilitating technological advances through expanded scale. However, instead of achieving the intended results, the firm issued multiple profit warnings in the short span of three months and share price of the new entity tumbled by 44% since April. SGRE's incorporation was completed just before a drastic drop in demand for wind turbines as the governments of India and US announced plans to reduce subsidies or tax incentives for wind power, a move that could affect 41% of SGRE's overall revenue. With the decline in the orders for its wind turbines, SGRE was forced to revise down its earnings forecast and trim its workforce to deal with the muted demand.

While there had been a shift towards renewable energy from conventional fuel source, demand for wind turbines shrunk substantially after governments in India, UK and the US announced the scaling back of subsidies for electricity generation using renewables. Prices of electricity generation through wind power has been on the decline, but they remain substantially higher than electricity generation through natural gas or coal in the absence of a subsidy. The retraction of subsidies will inevitably lead to lower demand for wind turbines, as cheaper alternatives such as coal and natural gas are favored over wind power. With the policy changes, SGRE is projecting annual orders to drop to an average of 111 turbines over the next 3 years, a significant decrease compared to the 249 orders at its peak in 2011.

At the same time, the slide in demand has started a price war among major turbine producers to retain their customers. After governments in Europe and the US phased out the use of subsidies and incentives for the purchase of turbines, prices of wind power technology dropped rapidly due to the lackluster demand. Additionally, the introduction of competitive auctions in major wind power markets since 2017 eroded away the pricing power of turbine producers like SGRE. In particular, the transformation of the Indian market from a subsidized market into an auction market during 2017 coincided with SGRE's sales underperformance. The increasingly competitive landscape is not only shifting demand away from wind power, margins within the wind power sector are being squeezed as well. SGRE's profitability could fall further as US lawmakers are contemplating to sharply reduce the value of tax credits for new wind power projects.

The sharp decline in wind turbine demand has resulted in excess capacity at SGRE which leads to unnecessary operating expenses. To eliminate the excess capacity, SGRE announced plans to cut 20% of its 26,000 workforce. Analysts say that slashing jobs is an effective countermeasure to lower expenses, but the bigger challenge for SGRE is to increase its topline in an environment with decreasing demand.

The term structure of the RMI-CRI Forward 1-year Probability of Default (Forward PD) indicates an increasing probability of default in the short term due to weak market demand and post-merger problems. The Forward PD represents the credit risk of a firm in a future period and works similarly to a forward interest rate. For instance, the 3-month Forward PD is the probability that the firm defaults during the period from 3 months onwards to 1 year plus 3 months, conditional on the firm surviving the next 3 months. The Forward PD for SGRE steepens with time to peak at around 15 months, suggesting that based on the market information on Nov 17, SGRE's financial situation is likely to continue worsening as the firm takes time to restructure its operations.

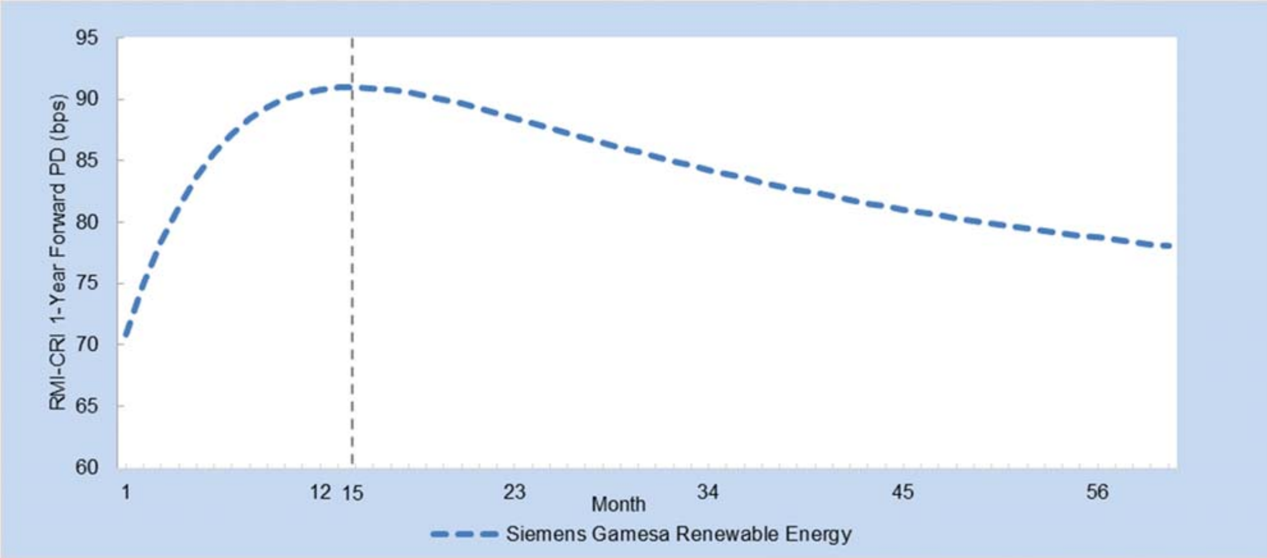

Figure 1: RMI-CRI Forward 1-year PD term structure for SGRE on Nov 17, 2017. *Source: RMI-CRI*

3 months ending	6/30/2016	9/30/2016	12/31/2016	3/31/2017	9/30/2017
EBITDA Margin (%)	12.52	12.39	25.74	13.69	8.91
Operating Margin (%)	9.90	9.58	10.78	11.20	1.86
Net Income (USD mn)	74.5	76.6	102.3	106.6	13.2

Table 1: Financial snapshot of SGRE, *Source: Bloomberg*

After consolidating income statements in April, SGRE reported lower EBITDA and operating margins in the recent quarter. Net income declined significantly driven by lower sales volumes and an inventory impairment incurred during the year. Management is taking active measures to cut down on its operating expenses, but the extent of decline in operating expense is likely to be smaller than the decline in its revenue. As a result, margins and profitability of the company could continue falling if demand conditions fail to improve.

In summary, SGRE is facing headwinds from both adverse market conditions and internal post-merger issues such as balance sheet consolidation. The company remains vulnerable to governmental policies on renewable energy which directly affects the demand for its products and services. Although the removal of subsidies and tax incentives may lead to undesired price competitions, this may be positive for large wind turbine players in the long run as it forces companies to get rid of their existing inefficiencies and become more competitive. In the short run, however, the credit profile of SGRE may weaken as the company is still in the midst of post-merger adjustments.

Credit News

India's first Moody's upgrade in 14 years bets on reforms

Nov 17. Moody's Investors Service raised India's sovereign rating for the first time since 2004, upgrading India to Baa2 from Baa3. According to Moody's, while India's high debt burden remains a constraint on the country's credit profile, the reforms put in place by Modi's government have reduced the risk of a sharp increase in debt, even in potential downside scenarios. In addition, the ratings firm lauded India for its USD 32bn program to recapitalize banks, which could revive lending and stoke demand. While Indian government officials hailed the upgrade as long overdue, some investors termed it a surprise, given that India recently surrendered its status as the world's fastest-growing major economy amid sweeping policy changes. Some investors have also cautioned that India still faces several challenges, such as a high debt burden and delayed labor and land acquisition reforms that leave little room for fiscal complacency, especially ahead of the 2019 elections. (Bloomberg)

Aircel joins Reliance Communications in debt default

Nov 17. Aircel has become the latest Indian telecom company to default on its loans, missing at least one interest payment to its consortium of lenders. This default occurred just days after Reliance Communications (RCom) defaulted on several bond repayments, as the launch of Jio, the low-cost telecom carrier set up by Mukesh Ambani, continues to take a toll on established companies. Since launching last September, Jio has attracted nearly 140mn subscribers by offering free calls and low-cost data, and other companies, which have responded with their own customer offers, suffered cuts in revenues and profits. To cope with the price war, some companies have considered merging with their rivals. In fact, Aircel and RCom had previously been in talks to merge, though RCom eventually cancelled the talks due to resistance from its creditors. (FT)

Household finances under strain as Nationwide warns of tough times ahead

Nov 17. Household finances are under worsening pressure and Nationwide building society has reported a fall in profits and warned of tougher trading conditions ahead. Total mortgage lending slipped from GBP 1.75bn to GBP 16.7bn due to a change in tax and lending rules. Half-year profits at Nationwide dropped to GBP 588mn from GBP 615mn and its future full-year profits are expected to be in the lower forecast range. Going forward, the UK economy will continue to grow but at a slower rate due to the uncertainties around Brexit. Meanwhile, competition in the mortgage and loans market would cause the society's market share to fall in the next six months. (The Guardian)

Fitch lowers Noble Group Rating, says default appears probable

Nov 17. Fitch Ratings cut the debt rating of Noble Group by a notch to 'CC' on November 17. The downgrade action followed the company's commencement of discussions on a debt restructuring, just weeks after it agreed to sell some assets and flagged a massive loss. Moody's has assigned a 'Caa3' rating on the group with a negative outlook and S&P Global has assigned a 'CCC-' rating with a negative outlook. Fitch said the company's liquidity situation has declined at the end of the last quarter as it had USD 262mn in unrestricted cash and USD 800mn in undrawn credit facilities against its USD 1.7bn short-term debt. Given the uncertainties regarding the profit generation of its operations, Fitch said it is unclear how Noble will address its debt maturities coming soon without a change to its capital structure. (Reuters)

African debt servicing costs hit 16-year high

Nov 16. The cost of servicing sub-Saharan African nations' debts has risen to the highest level since 2001 of an average of 12.2% of government revenues, up from a low of 5.4% in 2011. The IMF raised concerns that the rise in debt accumulation would increase public debt to unsustainable levels even in non-resources economies. The number of low-income countries that is facing a high risk of debt distress has increased from 7 to 12 in 2016. The growing debt problem was due to the widening fiscal deficits, disappointing economic growth, lower commodity prices and weaker currencies. The median debt-to-GDP ratio of the 18 sub-Saharan nations is projected to reach 52.6% in 2017 but is likely to fall slightly in 2018 and 2019. (FT)

Chaswood Resources says Malaysian unit in debt restructuring talks (Straits Times)

Banca Carige chief says rescue talks hit by ECB bad loan plans (FT)

Norway's USD 1tn wealth fund proposes dropping oil and gas stock (FT)

Regulatory Updates

Argentina to limit insurers' holdings in central bank notes

Nov 18. Argentina will limit insurers' holdings in central bank notes known as Lebacs as the government intends to directs more investments towards the country's infrastructure. Insurers will have to gradually reduce their holdings in mutual funds that invest in Lebacs by March next year. In recent years, Lebacs have been one of the most profitable investments in Argentina. Moody's views the government's move as credit negative for both insurers and mutual funds, saying that Lebacs are one of the most liquid and profitable instruments in local capital markets which represent a significant portion of the insurers' and mutual funds' investment portfolios. (Reuters)

China sets sweeping new rules to regulate USD 15tn asset management products

Nov 17. The Chinese government issued sweeping guidelines to tighten rules on asset management business on November 17, aiming to close loopholes that allow regulatory arbitrage, reduce leverage levels to curb asset price bubbles and rein in shadow banking activity. The guidelines unified rules covering asset management products issued by banks, trust firms, insurance asset management companies, securities firms, funds and futures companies. The new rules will set leverage limits for asset management products. Financial institutions will be forbidden from creating a 'capital pool' to manage funds raised, using asset management products to invest in commercial banks' credit asset or providing 'channel service' for other institutions to bypass regulations, also a 10% of management fee income from asset management products will be required as risk reserves. Non-financial institutions will be prohibited from issuing or selling asset management products. And highly-indebted companies will not be allowed to invest in such products. The transition period for the new regulations lasts until June 30, 2019. (Reuters)

Turkey's central bank should keep policy tight, deputy PM says (Reuters)

BIS releases further details on the assessment of globally systematically important banks (BIS)

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