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Brazil's credit rating downgrade deepens woes for Oi SA

by Dexter Tan

Last week, Oi SA's (Oi) USD 1.5bn 10-year notes dropped to the lowest value since they were issued in February 2012, following a downgrade of Brazil's sovereign credit rating. On Wednesday, S&P cut Brazil's rating to junk, taking away the investment grade the country enjoyed for seven years. As previously noted, Brazil could face a lengthy recession and highly leveraged firms like Oi, one of South America's largest telecom company, could continue to struggle in the face of mounting funding costs. According to RMI-CRI data, the 1-year Probability of Default (PD) for Oi has surged to 744bps on Sep 11, which is nearly 13 times the aggregate 1-year PD for 246 Brazil-domiciled companies.

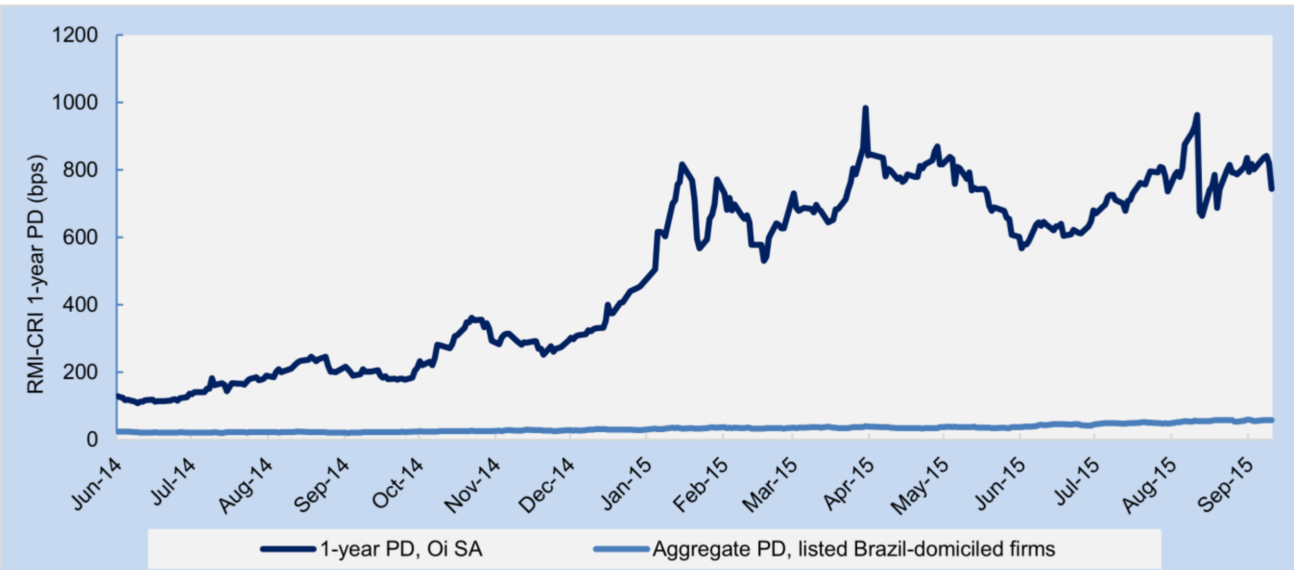

Figure 1: 1-year PD for Oi SA vs RMI-CRI 1-year aggregate PD for listed Brazil-domiciled firms. *Source: RMI-CRI*

Oi's market share in the telecommunications industry has been declining across all its business divisions (see Table 1). This is a result of its poor infrastructure quality as the company has not been investing to improve network equipment. The trend of increased mobile phone adoption and 4G usage has worked against the firm. Consumers are ditching their fixed line devices (Oi's main source of revenue) in favor of mobile phones, which are portable and becoming more affordable, even for users in rural Brazil.

Consumers are also using data networks to make phone calls as the voice quality of calls made over these networks have improved significantly. This is credit negative for Oi as the firm has the worst 3G and 4G coverage in the telecom sector. Last year, Oi also did not participate in the auction for the 700 MHz spectrum when Anatel (Agencia Nacional de Telecomunicacoes) invited the carriers to bid for the frequency. The 700 MHz spectrum is an important frequency due to its capacity to cover larger areas with fewer antennas.

Oi has the worst credit profile of all listed firms within the Brazilian telecom sector. The proportion of debt on its books, relative to EBITDA, is alarmingly high, nearly doubling from 3.39X in Q1 2014 to 6.48X in Q2 2015 (see Table 1). In June, the company issued EUR 600mn of senior notes, using the proceeds to refinance its current liabilities. Oi's downward cash flow trend shows that the firm is persistently burning cash, as retained cash flow to debt dropped sharply from 3.1% last year to -7.5% in Q2 this year. Despite efforts to cut costs, Oi's ability to cover its interest expense has been deteriorating, as the firm's coverage ratio drifted into negative territory during Q2, due to decreasing sales and negative net incomes in the last 3 quarters.

	Q1 2014	Q2 2014	Q3 2014	Q4 2014	Q1 2015	Q2 2015
Residential fixed line market share (%)	38.3	37.7	37	36.5	35.8	35.5
Broadband market share (%)	28.8	28.2	27.6	27.3	26.5	25.5
Pay-tv market share (%)	4.5	4.7	5.3	6.7	6.2	6
Mobile market share (%)				18.1	17.8	17.8
Debt / EBITDA multiple (X)	3.39	5.06	4.99	3.82	4.62	6.48
12m retained cash flow / Debt	-0.50%	3.13%	3.78%	3.64%	0.57%	-7.54%
Interest expense coverage multiple (X)	3.58	3.42	6.16	0.44	0.79	-0.14

Table 1: Oi's market share of the Brazilian telecom sector and credit metrics. Figures expressed in percentages, unless indicated otherwise. Income statement variables are based on trailing 12m performance. Retained cash flow = free cash flow – paid dividends. Interest expense coverage multiple defined as (Funds from operations + interest expense) / interest expense. *Source: Anatel, Bloomberg*

To improve the company's liquidity situation, Oi is looking to sell its 75% BRL 5.86bn stake in Africatel Holdings BV. The firm has been negotiating a sale with a potential buyer for three months, but the likelihood of a deal is uncertain. Samba Luxco, the non-controlling shareholder of Africatel, is exercising a put right under the shareholder's agreement, asking Oi to acquire the remaining 25% stake in Africatel. Oi refused and the company is in a legal dispute with Samba as the forced acquisition would deteriorate Oi's liquidity profile further.

Oi's Africatel stake is recognized as a held-for-sale asset, but its current valuation is still too low to give a significant improvement to the firm's credit profile. Our analysis shows 1-year PD for Oi is likely to remain at elevated levels even if the company manages to sell their African operations for BRL 5.86bn. The 1-year likelihood of default will decrease to 653bps[1] from its present level of 744bps on Sep 11. To have an implied[2] rating above 'B', management needs to sell the Africatel stake for more than BRL 5.86bn, and more importantly reduce their debt burden. The firm is cutting jobs, negotiating credit terms with its lenders and improving its corporate governance to boost investor relations. But more needs to be done if the company wants to increase market share and build its long term business success.

[1]Using August 2015 calibration parameters. In this hypothetical scenario, we adjust the DTD, Cash and M/B variables to calculate the new PD for Oi SA, assuming that the firm realizes BRL 5.86bn for the African arm. We assume Oi purchased Africatel at historical value and the firm would not book any profit or loss from the sale. All other Sep 11 input variables (i.e. Net Income, market cap…) remain the same.

[2]The PD upper bound for a 'B' equivalent rating is 521bps. Implied rating upper bounds are published in our Quarterly Credit Reports.

Credit News

BIS fears emerging market maelstrom as Fed tightens

Sep 13. Global debt levels are dangerously high and central banks cannot keep the game going indefinitely, warns the high priest of orthodoxy. The Bank for International Settlements said the wild market ructions of recent weeks and capital outflows from China are warning signs that the massive build-up in credit is coming back to haunt. Financial markets have worryingly come to depend on central banks' every word and deed. The BIS report said the rich countries have failed to right the ship over the last seven years or bring leverage back down to manageable levels. The concern is what will happen as the Fed prepares to raise interest rates for the first time since 2006, perhaps as soon as this week. (Telegraph)

Fears grow over US stock market bubble

Sep 13. A growing number of investors believe that US stocks are overvalued, creating the risk of a significant bear market, according to research by Yale University market scholar Robert Shiller. The Nobel economics laureate told the Financial Times that his valuation confidence indices, based on investor surveys, showed greater fear that the market was overvalued than at any time since the peak of the dotcom bubble in 2000. However, he made clear that it remained impossible to time any fall in the market, and cast doubt on whether stocks would drop should the Federal Reserve raise rates later this week. He said the recent bout of volatility shows that people are thinking something and re-evaluating their exposure to the stock market. (FT)

World Bank chief economist warns Fed to delay rate rise

Sep 9. In consideration of the rising uncertainty over growth in China and its potential impact on the global economy, the World Bank's chief economist warned the US Federal Reserve against the possibility of raising interest rates in September, in consideration of the risk in triggering panic in emerging markets. This advice coincides with the International Monetary Fund, as anxieties have grown in recent weeks about the potential repercussions of a September rate rise. World Bank's chief economist suggests that the Fed should only consider hiking the interest rates, when the global economy is more certain. (FT)

Quicksilver files for Chapter 11 bankruptcy in US

Sep 9. Struggling surf-wear maker Quiksilver Inc. said it filed for Chapter 11 bankruptcy protection for its U.S. units on Tuesday. The company said it listed assets of more than USD 100mn and liabilities of more than USD 500mn in the filing. The European and Asia-Pacific businesses are not part of the filing as those operations remain strong. The company said it had requested the court to approve USD 175mn in new debtor-in-possession financing with affiliates of private equity firm Oaktree Capital Management and Bank of America. Bloomberg reported last week that Quiksilver was trying to get bidders for a management-led buyout and that Authentic Brands Group could be interested if no strategic buyer came through. (CNBC)

Chinese banks demand Tianwei repay bonds early after default

Sep 8. Industrial Bank Co. and Huaxia Bank Co. asked Baoding Tianwei Group Co., a Chinese maker of power transformers, to repay two bonds early after it became the first state-owned enterprise to default on onshore debt in April. Industrial Bank is seeking RMB 793mn in principal and interest while Huaxia Bank has asked for RMB 248mn. The lenders sent requests for the notes due in December and March to the China International Economic & Trade Arbitration Commission. The demands come as investor concern about defaults escalates amid a slowdown in the world's second-biggest economy. Yingli Green Energy Holding Co. plans to raise money by selling land and using other cash flows to help cover Baoding Tianwei Yingli New Energy Resources Co.'s RMB 1bn bond coming due on October 13. (Bloomberg)

Carmakers braced for end to growth run (FT)

Puerto Rico to make debt restructuring proposal in a few weeks (Bloomberg)

Barnes & Noble stock sinks on wider loss (WSJ)

Regulatory Updates

UAE insolvency law to follow US Chapter 11 bankruptcy proceedings

Sep 13. The new UAE insolvency law is expected to contain provisions for corporate bankruptcy modelled on US chapter 11 bankruptcy proceedings. The insolvency law was passed by the Cabinet in July and currently requires the ratification of the consultative Federal National Council and of the Supreme Council. The law aims to encourage individuals to declare the insolvency of their companies, as well as cover investors' rights. It is also expected to cover provisions to decriminalize cheques and facilitate large corporate bankruptcies. The current draft law aims to regulate accumulated debts, eases restructuring of companies and support troubled businesses. This aims to reduce risk of companies' bankruptcy and foster a safe and attractive business environment in the UAE. (The National)

China plans shake-up of state-owned enterprises to boost growth

Sep 13. China has revealed the long-awaited guidelines for the reform of its state-owned enterprise (SOE) sector as the latest official data shows that its economy continues to slow. The call for the reform of SOEs, which includes the area of share sales and management changes, was timed to reduce losses and enhance efficiency in the SOE sector. The guideline from China's State Council aims to complete the reforms of the SOEs by 2020. This reform aims to make China's economy more vibrant and SOE more risk-resistant. (FT)

Beijing clamps down on forex deals to stem capital flight

Sep 10. China has imposed capital controls as it attempts to contain the repercussion caused by the devaluation of the Chinese Yuan. The devaluation on Aug 11, 2015 created uncertainty in the global stock market and policy confusion in China, forcing the central bank to spend USD 200bn in order to support the Yuan. The possibility of the US raising the interest rate has also encourage capital flight. China has used capital controls in the past but they have broken down in recent years as the Yuan has become more widely used around the world. (CNBC)

UK auditors sound public-sector debt warning (The Guardian)

HK regulator blasts Moody's for 'shoddy' report on China firms (Straits Times)

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