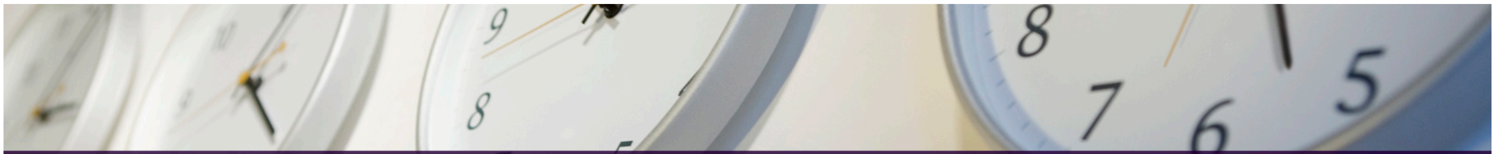

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2 July 2020

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Expanded Texas order suspending non-essential surgeries is credit negative for hospitals

Originally published on 30 June 2020

On 30 June, Texas Governor Greg Abbott expanded an executive order suspending elective surgeries in hospitals in Bexar, Dallas, Harris and Travis counties to now include the counties of Cameron, Hidalgo, Nueces, and Webb. The move is credit negative for rated for-profit hospital companies that operate in these locations because it threatens to dampen earnings from facilities in those counties and slow the companies' overall recovery.

Many for-profit hospitals have significant exposures to Texas; the eight affected counties are among Texas' most populous, serving the major cities of San Antonio, Dallas, Houston, and state capital Austin. Since elective surgeries are a primary source of profit for acute care hospitals, a sustained pause on elective surgeries in those counties or an expansion to others in Texas would weaken revenue and profit for a number of for-profit hospitals.

Texas Governor Greg Abbott issued the order to try and preserve the hospitals' capacity, including beds in intensive-care units (ICUs), to handle the surging numbers of COVID-19-related hospitalizations. However, the language in the executive order gives physicians and hospitals some flexibility over which surgeries they consider medically necessary. Further, the governor's order does not currently include ambulatory surgery centers (ASCs), allowing hospitals with these facilities to continue to perform many elective procedures on an outpatient basis. These two factors differ from the nationwide pause on elective surgeries that was mandated in March/April, likely resulting in a less severe drop in surgeries in Texas than hospitals experienced earlier on. Still, the action will likely disrupt what had been the beginning of a healthy recovery in hospital volumes in late-May and early-June. As other hot spots emerge, like Florida (another important market for for-profit hospitals), additional moves to restrict elective surgeries or reinstate lock-down measures in certain areas will further disrupt the recovery.

For-profit hospitals with significant exposures to Texas include HCA Healthcare Inc. (Ba1 stable), which derives about 26% of its revenue from Texas, and AHP Health Partners Inc. (B3 stable), which derives about 35% from the state. Universal Health Services Inc. (Ba1 stable) derives about 16% of its revenue from Texas, including both its acute care and behavioral health businesses, while roughly 23% of Tenet Healthcare Corporation's (B2 stable) hospital beds are in Texas. CHS/Community Health Systems Inc. (Caa3 stable) relies on Texas for roughly 12% of its revenue.

We believe that these larger for-profit hospital systems are better positioned now than they were in March/April to handle a surge in COVID-19 patients. These companies are geographically diverse and have experienced surges in COVID-19 patients in other markets, even though Texas was not a hot spot earlier on. For example, AHP Health Partners also has a significant presence in New Jersey, which experienced significant COVID-19 volumes earlier in the US pandemic. This gives companies better insight into how to manage staffing, the flow of patients and preserve bed capacity.

Additionally, many of these companies have acquired significant amounts of personal protective equipment in recent months. Such factors, along with significantly greater access to COVID-19 testing and faster lab turnaround times, will enable the larger hospitals to be able to manage surging COVID-19 patients without the significant operational disruption that many hospitals witnessed earlier in the pandemic. Also, the larger hospitals have flexibility to direct patients to affiliated ASCs. For example, Tenet and HCA operate a significant number of ASCs in Texas. That said, smaller (largely not-for-profit) hospitals may not be as resilient in the face of surging COVID-19 admissions.

The order and ensuing decline in surgeries also has negative credit implications for various post-acute providers that depend to some degree on acute care hospitals for referrals, including inpatient rehabilitation facilities (IRFs), long-term acute care hospitals (LTCHs) and behavioral health facilities. But exposures to Texas vary by company. About 18% of Encompass Health Corp.'s (Ba3 stable) IRFs are based in Texas, along with roughly 7% of Kindred Healthcare LLC's (B2 stable) combined IRFs and LTCHs. Only 6% of Select Medical Holdings Corporation's (B1 stable) LTCHs and IRFs are based in Texas.

Meanwhile, the for-profit hospitals have significantly improved their liquidity in recent months. Many have received grants and accelerated Medicare payments from the Coronavirus Aid Relief and Economic Security Act, or CARES Act, and have raised debt in the capital markets. Funds in place today will help ease the strain of the Texas executive order and other isolated geographic setbacks as the COVID-19 pandemic evolves.

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PowerTeam's $150 million senior note tack-on is credit negative

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On 30 June, PowerTeam Services, LLC (B3 stable) announced its intention to issue a $150 million tack-on to its 9.033% senior secured notes issued in May 2020, a credit negative. The tack-on will raise the company's interest costs, replace pre-payable debt with notes that mature in December 2025 and could add execution risk if the additional funds support acquisitive growth shortly after the transformative acquisition of MVerge.

PowerTeam plans to use the proceeds from the $150 million notes tack-on to pay off its credit facility and accounts receivables securitization facility borrowings. This transaction will strengthen the company's liquidity and provide funds to pursue growth opportunities. However, it will raise the company's interest costs by about $11 million, replace prepayable debt with notes that mature in five-and-a-half years and add execution risks if the company's uses the added liquidity to pursue acquisitive growth shortly after completing the transformative acquisition of MVerge in April 2020.

PowerTeam issued $587 million of 9.033% senior secured notes in May 2020 to redeem notes that funded a portion of the acquisition of Miller Pipeline and Minnesota Limited (collectively, MVerge) for $850 million from CenterPoint Energy, Inc. (Baa2 negative) on 9 April 2020. Miller Pipeline and Minnesota Limited are natural gas distribution and transmission pipeline contractors in the US. The acquisition was credit positive since it raised PowerTeam's pro forma revenues to more than $2 billion, enhanced its geographic and operational diversity and created a leading US provider of maintenance and construction services for electric and natural gas infrastructure. The transaction was also deleveraging due to PowerTeam's very high leverage prior to the acquisition and the equity contribution by PowerTeam's owners (principally Clayton, Dubilier & Rice) to fund a portion of this transaction. The majority of the deal was funded with debt.

PowerTeam's operating performance was weak for the second consecutive year in 2019, affected by customer suspensions combined with lower storm-related activity and fewer large transmission projects. These issues led to its adjusted EBITDA declining about 30% over the past two years and its leverage ratio (debt/ EBITDA) rising to about 8.5x in December 2019 from 5.1x in December 2017. The MVerge transaction is materially deleveraging on a pro form basis and both companies have had a strong start in 2020 because of improved productivity and increased project and service work aided by favorable winter weather.

The company's focus on utility customers and its exposure to maintenance, repair, replacement and upgrade work for about two-thirds of its revenue should provide a downside buffer despite weaker economic activity in the near term. Therefore, we anticipate the company's pro forma adjusted leverage ratio will approach 6.5x and its interest coverage (EBITA/interest) about 1.5x including the tack-on notes. The metrics are commensurate with its B3 corporate family rating.

Headquartered in Atlanta, PowerTeam is a domestically focused natural gas distribution, transmission and electric services company for natural gas and electric utilities and midstream operators offering a wide array of services that help maintain and upgrade their infrastructure and operate more efficiently and reliably. The company generated pro forma revenue of more than $2 billion over the 12 months to year-end 2019. Clayton, Dubilier & Rice acquired majority ownership of PowerTeam in 2018.

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Howmet Aerospace's revolving credit facility amendment is credit positive

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On 29 June, Howmet Aerospace Inc. (Ba3 negative) announced that it amended certain covenants under its revolving bank credit facility, a credit positive. The company's proactive covenant relief is in line with that of several companies' actions to improve liquidity amid expected weaker demand because of the coronavirus pandemic.

The amendment resetting the company's financial maintenance covenant under its revolving credit facility will meaningfully increase covenant headroom beginning in Howmet's second quarter of this year (30 June 2020) and effective through the fourth quarter of 2021 (31 December 2021). The bank-defined net debt/EBITDA covenant is being reset during the covenant relief period, increasing 1.5x to 5.0x from the current 3.5x (that has no step-downs) through the end of 2020, increasing to 5.25x for the covenant period ending 31 March 2021 as the stronger quarters from the prior year roll off. In 2021, the net/debt EBITDA covenant will gradually step down to 4.0x from 5.25x before reverting back to 3.5x in 2022. Given the likely protracted nature of the aerospace downturn prompted by the coronavirus pandemic and soft commercial vehicle end markets, the extended duration of the covenant relief period will support the company's liquidity profile.

The company's net debt/EBITDA covenant positively allows for the subtraction of a meaningful amount of Howmet's cash balance, which was a sizable $1 billion after the spin of Arconic Corporation on 1 April 2020. The covenant allows for the subtraction from funded debt of cash balances exceeding $400 million.

However, the amendment also reduces the size of the company's revolving credit facility by one third to $1.0 billion from $1.5 billion. Nonetheless, the facility's smaller size is counterbalanced by our expectation that the revolver will remain undrawn, and that the facility comprises 20% of Howmet's expected revenue base over the next two to three years.

In tandem with many other such covenants, the amendment contains a provision that limits restricted payments subject to certain baskets contained in the agreement that are dependent on the company meeting certain predefined financial leverage metrics. This favorably limits aggressive shareholder remuneration evident in 2019, primarily in the form of sizable share repurchases.

The recent amendment to the credit facility is the latest in a series of actions the company has taken to improve liquidity. In Howmet's first-quarter 2020 earnings call, the company publicly stated measures to preserve liquidity as it contends with the negative impact of the coronavirus pandemic including targeting $100 million of run-rate savings (incremental to the $50 million announced in 2019) and reduction in capex target by approximately $100 million. In addition, the temporary dividend suspension will also contribute to preservation of liquidity. The company's sizable cash balances, access to its $1 billion revolving credit facility as well as expectation of positive free cash flow for 2020 underlie our expectation that the company will maintain a good liquidity profile as it contends with the pandemic.

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Xilinx revenue trend improves versus expectations as coronavirus disruptions ease

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On 29 June, Xilinx Inc. (A3 stable) preliminarily reported June quarter revenue of $727 million, above the high end of revenue guidance it provided on 22 April for the June quarter and up 5.4% from the midpoint of that revenue guidance. On a year-over-year basis, the preliminary revenue will decline 14% versus our earlier expectations of a 19% decline. Although revenue is still down year over year, the better-than-expected revenue guidance is credit positive versus two months ago, when management highlighted deteriorating global demand and increased customer caution amid the fluid COVID-19 environment.

Xilinx noted that while it experienced some COVID-19 effects in the quarter, the business performed better than expected in the wired, wireless, and datacenter markets that offset the weaker revenue in automotive, broadcast and consumer. On a modestly cautionary note, some of the upside to revenue was helped by customer pull-ins, with the company noting that "a portion of the revenue strength in the quarter was due to customers accelerating orders following recent changes to US government restrictions on certain of our products to international customers." Alleviating this concern, Xilinx said preliminary September quarter revenue would be flat sequentially, which is consistent with historical June to September revenue trends and suggests that broad based demand could be in a bottoming phase.

Xilinx's credit profile reflects its leading position in the $6 billion programmable logic device (PLD) market where Xilinx has over 55% market share and competes mostly with just one other company (Altera, owned by Intel). Although PLDs are a small portion of the semiconductor market, they provide end users product design flexibility and time to market advantages over other semiconductor devices and there are high barriers to entry for new competitors.

Xilinx has generated positive free cash flow each year for more than a decade, and we expect ongoing strong credit metrics even in the currently challenging macro environment. Long product design and lifecycles and stable pricing contribute to strong profitability (mid-30% EBITDA margins) and stable operating performance through business cycles. Despite the very challenging macro environment, we expect Xilinx will produce solidly positive free cash flow, even through a stress environment, given the company's strong profit margins, low capital expenditures, and very strong conversion (88%) of EBITDA into cash flow after capital spending.

We expect the company's financial policies will remain conservative, including maintaining moderate financial leverage and an excellent liquidity profile and limiting share buybacks during these challenging times to preserve balance sheet liquidity. Xilinx has over $2.5 billion of cash and no debt maturities until $750 million matures in 2024. We project gross adjusted debt to EBITDA at around 1.8x for the fiscal year that ends March 2021 (about 0.5x lower excluding the company's transition tax liability) and free cash flow to gross adjusted debt of 25%, or about 40% excluding the transition tax liability.

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South Africa extends tobacco ban to over four months, a credit negative for BAT

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On 26 June, British American Tobacco (BATSA), a fully owned subsidiary of British American Tobacco p.l.c. (BAT, Baa2 stable), said that a hearing of its legal case against a ban to sell any tobacco product in South Africa had been delayed by around six weeks to early August, effectively extending the ban to at least four and a half months this year. Although the financial implications for BAT are negligible given the small size of the South African market relative to the group's overall size, the ban is credit negative for BAT because it highlights the heightened social risk to which tobacco manufacturers are exposed amid the coronavirus pandemic.

South Africa is the only country worldwide to have introduced a temporary ban on tobacco, but we cannot rule out the possibility that other countries will introduce bans during a potential second wave of the pandemic, affecting sales and the credit metrics of BAT and other tobacco manufacturers.

The South African government cited concerns that COVID-19 may have more severe effects on smokers as its justification to impose the ban. The country introduced strict lockdown measures at the end of March, including a ban on the sale of alcoholic drinks, combustible tobacco and e-cigarettes, but restrictions on alcohol were eased in early June while the ban on tobacco was extended.

The South African government decision is clearly following the instructions of the World Health Organisation (WHO), which has long warned about the health risks of smoking. The WHO also has dismissed entirely any potentially positive effect of nicotine, a key ingredient of cigarettes, on COVID-19 patients, as suggested by a French study published in April. Meanwhile, the government has disregarded the tobacco industry's claims that consumers have not quit smoking during the ban but instead are buying cigarettes on the black market, which already comprise around 40% of total tobacco sales in South Africa.

BAT does not disclose financials on single markets, but according to media reports BATSA controls around 80% of South Africa's legal cigarette market. South Africa's annual tax revenue from tobacco products totaled ZAR11.067 billion (£519.6 million) in 2017-18, according to the WHO's 2019 country profile. The tax rate on the most-sold brand of cigarettes was 54.6% in 2018, based on the report. Assuming the group's EBITDA margin of 44.2% in 2019 applies to its South African operations, we estimate that BATSA generated an EBITDA of approximately £153 million last year, or 1.3% of group EBITDA. If BAT were to lose all of the EBITDA generated in South Africa for 12 months, its pro forma 2019 leverage, defined as Moody's-adjusted gross debt to EBITDA, would only increase to 4.0x from an actual 3.9x.

However, if more countries consider similar bans during a potential second wave of the pandemic, should it arise, the effect would clearly be greater, and affect other tobacco manufactures. So, while on its own the South African ban is negligible on BAT's debt metrics, the case highlights the social risks to which BAT and the whole tobacco industry are exposed, particularly during a pandemic.

South Africa had 124,690 COVID-19 cases and 2,340 deaths as of 27 June 2020, according to Johns Hopkins Coronavirus Resource Center. Around 20% of the population, or 11 million people, are smokers in South Africa.

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Swedish regulator fines SEB SEK1 billion for Baltic operations' money-laundering deficiencies

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On 25 June, Sweden's Financial Supervisory Authority (SFSA) concluded its sanction proceedings against SEB AB (Aa2/Aa2 stable, a3[1]) by issuing a remark and imposing a SEK1 billion fine on the bank. The remark, which is a less severe administrative sanction than a formal warning, and the fine followed the SFSA's findings of deficiencies in the bank's anti-money-laundering (AML) framework and process. The investigation also concluded that parts of the bank's Baltic operations have been exposed to elevated risk of money laundering, a credit negative.

The SEK1 billion (€95 million) fine equals 14% of the maximum fine that the SFSA could have imposed[2]. According to the SFSA, its findings were not negligible but also not severe.

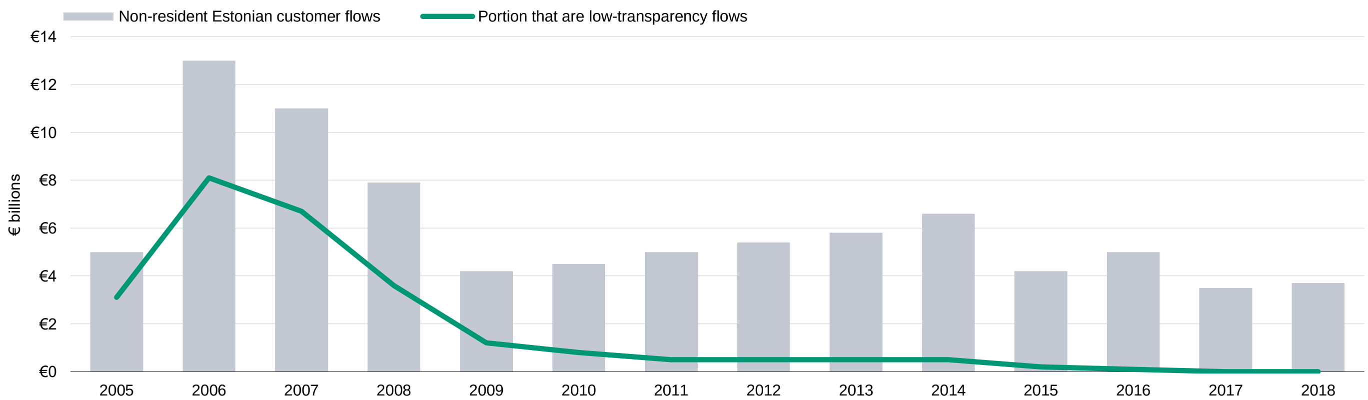
The sanction proceedings began in December 2019 as part of the SFSA's ongoing investigation into the bank's management and control of money-laundering risk in its Baltic operations. SEB is Sweden's second-largest bank and has a significant presence in the Baltics, being the largest bank in Lithuania and the second largest in Estonia and Latvia. The investigation covered the period from 2015 to first-quarter 2019. According to SEB, the SFSA conducted its investigation in cooperation with Baltic supervisory authorities, and both Swedish and Baltic supervisory authorities have now concluded their investigations regarding SEB's AML framework, removing the risk of further regulatory sanctions from these authorities.

The SFSA's investigation uncovered deficiencies in the bank's governance and control of its Baltic subsidiary banks' AML, its resources dedicated to money-laundering prevention and its corrective actions even after repeated warnings about inadequacies in its AML framework.

SEB also failed to identify and manage its Baltic operations' elevated compliance and money-laundering risk, which reflects the relatively higher risks in these operations and the nature of the Baltic subsidiaries' customer relationships. According to the SFSA, in parts of SEB's Baltic operations, nonresident customers have comprised a significant share of transaction volume, particularly for deposits. A large part of the nonresident volume has been associated with customers which have been classified as high risk by the subsidiaries. Furthermore, a proportion of resident customers' volume was identified by the SFSA as posing a higher risk, due to these customers having non-resident beneficial owners. This reflects weaknesses in the bank's information about beneficial owners before 2016.

However, according to the SFSA, nonresident transaction volumes declined during the investigation period. The statement is in line with recent bank data on past nonresident transactions in its 2005-18 Estonian operations, which indicated that a sizable portion of these flows, particularly during 2005-08, had a heightened risk of money laundering. These low transparency transactions declined gradually as of 2007, reflecting the bank's actions to strengthen its AML routines and processes (see exhibit). At the group level, SEB continues to develop its know-your-customer capabilities, including investments in digitalisation.

Low transparency flows at SEB's Estonian operations have fallen significantly
SEB's disclosure of past transactional data



Bank defines low transparency flows as transactions that do not meet current know-your-customer criteria or cannot be easily linked to a legitimate business reason.
Source: SEB

We expect the fine to have a limited effect on the bank's franchise given the bank's corporate focus and longstanding relationships with large corporates, as well as its strong domestic market positions in retail and commercial banking. Moreover, the deficiencies the SFSA noted have broadly been addressed, reducing the risk of future failures.

SEB currently has solid capital buffers that can absorb the fine, with a Common Equity Tier 1 ratio of 16.8% as of March 2020, exceeding its regulatory requirement by 310 basis points. The fine equals 5% of the bank's 2019 earnings. Although SEB's profitability will weaken following the coronavirus-induced economic disruption (with the fine equaling 42% of first-quarter 2020 earnings), we expect that the bank's earnings-generation capacity will be sufficient to absorb this amount, and that the fine's incremental effect on the bank's credit profile is contained.

SEB's fine follows the SFSA's March 2020 formal warning and a SEK4 billion fine, which was equivalent to 71% of the maximum fine that the SFSA could have imposed, of Swedbank AB (Aa3/Aa3 stable, baa1) for money-laundering involving its Baltic operations. SFSA said that its investigation into Swedbank revealed deficiencies so serious that it had considered revoking the lender's banking license but refrained because Swedbank's efforts to upgrade its AML processes demonstrated a willingness to rectify the flaws that the SFSA investigation revealed.

Endnotes

1 The bank ratings shown in this report are the bank's deposit rating, senior unsecured debt rating and Baseline Credit Assessment.

2 The SFSA's maximum fine equals 10% of a company's turnover.

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National Commercial Bank's potential merger with Samba would enhance its franchise in Saudi Arabia

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On 25 June, National Commercial Bank (NCB, A1 negative, baa1[1]) and Samba Financial Group (A1 negative, a2) entered discussions about a potential merger. Both companies must complete due diligence and agree on the final price, and neither bank is obligated to proceed with the transaction. If the companies reach an agreement, closing would be subject to various conditions including but not limited to regulatory and shareholder approvals.

A merger would be credit positive for NCB because its capitalization would strengthen and the deal would reinforce its position as Saudi Arabia's biggest bank in terms of its market share of systemwide assets. NCB would benefit from Samba's strong corporate and investment banking franchise and well-established risk management practices.

The merger would combine NCB's large franchise across most business lines and mass retail capabilities with Samba's upper-middle-income retail presence and well-established corporate banking franchise, which is particularly strong in syndications and project finance, cash management, treasury products and corporate finance. The merged bank's higher capital and status as Saudi Arabia's largest domestic bank and third-largest in the Gulf Cooperation Council would position it to compete for the biggest local and regional projects. The Saudi government through various government entities owns 64% of NCB and close to 50% of Samba. Therefore, the chances of a deal being reached are better and the combined entity would benefit from a very high likelihood of government support, in case of need.

NCB had about a 19% share of total consolidated Saudi banking system assets at year-end 2019 and the merger will increase that market share to 29% and the deposits market share to 30%. The merged entity's tangible common equity ratio to adjusted risk weighted assets would increase to above 16% on a pro forma basis from NCB's 15.1% at year-end 2019 because of Samba's higher tangible common equity ratio of 17.6%. NCB would benefit from Samba's strong corporate and investment banking franchise, and robust risk management that translates into Samba's cost of risk consistently being one of the lowest in Saudi Arabia. The merger would also dilute NCB's more risky exposure to Turkey through its majority- owned subsidiary Türkiye Finans Katılım Bankası to less than 5% of NCB's total assets from 7% as of December 2019. Türkiye Finans Katılım Bankası's nonperforming loans (NPLs) were around 9% of its total loans as of year-end 2019.

NCB, the surviving entity, would likely absorb Samba's creditors, who will benefit from NCB's stronger franchise and balance sheet, with more diversified operations and income streams and higher pre-provision income because of NCB's extensive retail operations. Samba has a sophisticated and well managed global market and treasury business that has the potential to prove useful for the combined entity's larger balance sheet. Both banks have healthy funding and liquidity profiles, which will be maintained in the combined entity.

In the first few years after a merger, profitability will likely be negatively affected because of related expenses and integration risks, but we expect later synergies to support operational efficiency and profitability. The merger also has initial integration risks and a potential loss of focus on executing approved budgets and projects given its size. Therefore, we expect some initial loss of business, which would likely be regained after the merger's completion.

Endnotes

1 The bank ratings shown in this report are the bank's deposit rating and Baseline Credit Assessment.

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Amendments to India's bank resolution framework are credit positive

On 26 June, the Indian government amended the Banking Regulation Act, 1949, allowing the Reserve Bank of India (RBI) to initiate the resolution of a weak bank by reconstructing its capital or merging it with another bank without the prior requirement of imposing a moratorium on its depositors and creditors. The amended resolution process is credit positive because it will help preserve depositor confidence and avoid deposit flight from a weak bank as the risk of a moratorium is reduced.

The amendments are also credit positive for the bank's depositors and creditors because their ability to obtain full and timely repayments during the resolution process are unaffected.

Before the amendments, the RBI could only initiate the resolution process of a weak bank after seeking approval from the Indian government to impose a moratorium on the bank's assets and liabilities for up to six months.

On 5 March, the RBI imposed a 30-day moratorium on Yes Bank Limited (Caa1 positive, ca[1]) because of its weakening solvency and liquidity. We regard a moratorium as an event of default, because it prevents a bank from making a full and timely payment to its senior creditors.

The moratorium on Yes Bank was lifted after 13 days, after the Indian government approved a reconstruction plan in which a number of public and private sector banks infused new equity capital into the bank.

Although the bank's depositors and senior debt holders were rescued by the Indian authorities, the bank experienced a significant outflow of deposits in the run-up to the moratorium and after it was lifted. Between December 2019 and March 2020, Yes Bank's deposits declined by 36%, leading to a sharp deterioration in its liquidity.

Endnotes

1 The bank ratings shown in this report are the bank's domestic deposit rating and Baseline Credit Assessment.

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Singapore's proposed environmental risk guidelines for financial institutions are credit positive

On 25 June, the Monetary Authority of Singapore (MAS) issued proposed guidelines for financial institutions' environmental risk management and accountability. The proposed guidelines set out MAS expectations of Singapore financial institutions' clear and transparent environmental risk identification and assessment.

The proposed guidelines would be credit positive because they will strengthen Singapore financial institutions' oversight and management of environmental risks. The coronavirus pandemic has sharpened the focus of regulators, investors and issuers on environmental, social and governance (ESG) factors and their increasing relevance in assessing credit risk.

The proposed guidelines require financial institutions' board members and senior management to assume responsibility for setting up environmental risk frameworks and for environmental risk oversight. The requirement will ensure Singapore financial institutions incorporate environmental risk in their business planning and decision making.

The guidelines, when implemented, will benefit banks by setting transparent standards on managing environmental risks. Banks will have to incorporate an environmental risk assessment in their assessment process for credit facilities and capital market transactions. They will also have to engage with borrowers with higher exposure to environmental risk to help improve their environmental risk profile and transition to sustainable practices. Moreover, the proposed guidelines require banks to develop tools, including scenario analysis and stress testing, to monitor and assess exposure to environmental risk.

The introduction of environmental stress tests will reduce the potential financial, regulatory and reputational burden on banks from their environmental exposures. The scenario analysis and stress testing approach proposed by the MAS, based on an impact analysis of material environmental risk, will help banks identify potential risks in their loan portfolios and review their environmental risk management policies and practices on a forward-looking basis. The benefit will be particularly large for banks with significant exposure to high-risk sectors, such as energy, infrastructure, chemicals, agriculture and forestry, and metals and mining.

The proposed guidelines are also positive for insurers because they should help reduce underwriting and investment losses from their environmental risk exposure.

The new guidelines, as part of the underwriting process, will require insurers to assess the environmental risk of policyholders and incorporate this assessment in setting insurance premiums. Such an assessment will help improve risk selection and underwriting profitability, and will be particularly relevant to nonlife insurers and reinsurers, which are exposed to property damage and liability claims stemming from disasters.

The proposed guidelines also require insurers to develop tools to assess the environmental effect on individual investments on an ongoing basis as part of their investment process. This will reduce potential impairment losses from stranded assets as a result of environmental regulation changes or the loss of economic value of such assets to more carbon-friendly alternatives.

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Great-West's acquisition of Personal Capital is credit positive

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On 29 June, Great-West Lifeco, the primary operating entity of Canada Life Assurance Company (insurance financial strength Aa3 stable) and a leading Canadian life insurance and asset management group, announced that it had signed a definitive agreement to acquire Personal Capital, a hybrid digital/advisor-driven wealth management platform. The transaction price is $825 million in cash plus a conditional deferred consideration of $175 million. The acquisition is credit positive for Great-West and its US-based Empower Retirement pension and asset administration unit because it provides a new distribution channel that will offer advice and products to its existing retirement and wealth management base, as well as new clients, potentially enhancing incremental assets under management (AUM) and fee-based profits over time.

However, the financing of the acquisition, which will include $500 million of debt, will incrementally increase Great-West Lifeco's leverage metrics. Great-West's adjusted financial leverage was around 26% at year-end 2019, while total leverage was approximately 30%. Additionally, goodwill and intangibles will rise, while regulatory capital at its US subsidiary, Great-West Life & Annuity Insurance Company (insurance financial strength Aa3 stable), will decline somewhat.

Personal Capital is a fast-growing, hybrid robo/registered investment advisor that provides a comprehensive online financial planning tool to individuals, allowing them to manage all of their assets (banking, investment, retirement, etc.) in one place. The financial information gathered by the online tool is then used to generate leads whom human advisors try to convert into real buyers of advice and retirement products and services.

The acquisition will allow Empower Retirement, the second-largest defined-contribution recordkeeper in the US, as measured by second-quarter 2020 participants, to make the tool available to its 9.7 million retirement plan participants, potentially increasing incremental AUM and fee-related income over time. It will also expand the company's product offering, narrowed by the sale of most of its individual life insurance and annuity business to Protective Life Corporation (Baa1 stable) via reinsurance in June of last year. The parties expect the transaction to close in the second half of 2020, subject to regulatory approvals.

Given the continuing economic and human fallout from the coronavirus pandemic, with unprecedented unemployment levels, conversion rates of tool usage into real sales, AUM and new fee income are likely to be challenging this year, if not longer. Even when the situation improves, the retirement savings sector is intensely competitive and crowded, so significant new sales and profits are not guaranteed, especially since many large competitors offer a wider variety of investment, retirement and insurance products and services (see exhibit).

Empower is a leading retirement services provider in a crowded field

	Company	Rating* and outlook	Total 401(k) assets ($ millions)
1	Fidelity Investments	A1 stable	$1,636,484
2	Empower Retirement[1]	Aa3 stable	$400,486
3	Alight Solutions	B2 stable	$375,562
4	The Vanguard Group, Inc.	Unrated	$374,559
5	Voya Financial	A2 sttable	$196,284
6	Wells Fargo	A2 stable	$190,985
7	T. Rowe Price	Unrated	$158,756
8	Prudential Retirement	Aa3 stable	$147,497
9	Bank of America	A2 stable	$147,055
10	Principal Financial Group	A1 stable	$143,359
	Total		**$3,771,027**

*Rating is of leading life insurance subsidiary, unless otherwise noted. Fidelity Investments' rating is a senior debt rating. Empower is the brand name of the Great-West Life and Annuity Insurance Company, whose rating is represented in the chart. The rating for Alight, a provider of outsourced healthcare and retirement benefits administration services and human resources technology solutions, is a corporate family rating. Wells Fargo & Company's rating is its holding company senior unsecured debt rating. It sold its Individual Retirement & Trust

Business to Principal Financial Group in 2019. Prudential Retirement is a division of the Prudential Financial Group. Bank of America Corporation's rating is its holding company senior unsecured debt rating.
Sources: PLANSPONSOR Recordkeeping Survey 2019 and Moody's Investors Service

But, digitally driven insurance distribution platforms have gained traction, even before the pandemic hit. In 2019, Prudential Financial, Inc. (A3 stable) acquired Assurance IQ, a direct-to-consumer distribution platform providing customized health and financial wellness solutions. Similar to Personal Capital, Assurance IQ is an online distribution platform that matches buyers with customized life, health, Medicare and auto insurance, allowing them to purchase entirely online, or with the assistance of a live agent.

Given stay-at-home decrees driven by the pandemic, both individuals and insurers have been forced to embrace technology more extensively in their daily activities, and at a faster pace. This bodes well for distribution models such as Personal Capital after the pandemic subsides.

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Cyberattacks on Ethiopian websites exacerbate tension with Egypt over Nile River dam

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On 27 June, Ethiopia (B2 review for downgrade) reported that several government websites were cyberattacked from sources originating in Egypt (B2 stable). Notwithstanding the attacks' limited success, they add a new dimension with potential negative credit consequences to simmering tensions with Egypt over the ongoing construction of the $4.8 billion Grand Ethiopian Renaissance Dam (GERD) being built on the Nile River .

Hackers made Ethiopian government agency websites inaccessible for a time and indicated that they were opposed to Ethiopia's damming of the Nile. The attack was a one-off event that has been largely thwarted and is unlikely to have long-lasting effects on Ethiopia's core credit metrics or credit profile.

However, the attack indicates that Ethiopia is vulnerable to cyberattacks, in part reflecting limited resources to dedicated to cybersecurity. A cyberattack is most likely to undermine a sovereign's credit profile by weakening institutional and governance strength, potentially increasing political risk and reducing economic strength. Cybersecurity is increasingly important as coronavirus-related lockdown measures increase online transactions, which rely on business and consumer confidence in network security and stability.

A dispute over the dam's net benefits for the region has been a significant source of geopolitical risk between the two countries since Ethiopia broke ground for the dam in 2011. Managing a shared water resource in the water-scarce Nile basin is challenging, not least given myriad nonbinding agreements going back decades that complicate consensus. After several rounds of diplomatic negotiations over the past year involving mediators including the US and the World Bank Group, no binding agreement on the key sticking point – the timing and pace of filling the GERD reservoir – has been reached. Ethiopia planned to begin filling the reservoir in July, but acquiesced to a delay because Egypt said filling the reservoir threatens water sustainability downstream and risks significant damage to ecosystems.

The successful completion of the GERD and its full operation offers Ethiopia and neighbouring countries such as Sudan, Djibouti and Kenya (B2 negative) a source of low-cost electricity that will enhance growth prospects and boost Ethiopia's external position with steady cross-border energy sales. The energy sales will generate much-needed foreign exchange for Ethiopia, whose reserve levels are historically low at less than two months of imports cover and which pose a persistent constraint on Ethiopia's credit profile. Cyberattacks aimed at delaying the project threaten the anticipated improvements in Ethiopia's economic growth and external position.

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Fewer Pennsylvania school districts seeking exception to tax cap is credit positive, but funding risks linger

On 1 July, Commonwealth of Pennsylvania (Aa3 stable) school districts began state fiscal year 2021 (ending on 30 June 2021) in strong financial shape as a sector, exemplified by a trough in the number and value of exceptions to the Act 1[1] cap on property tax increases. Fewer school districts seeking Act 1 exceptions shows Pennsylvania school districts' improved fiscal health over the past five years. However, coronavirus-induced state budget challenges bring potential funding hurdles over the longer term.

Districts seeking fewer Act 1 exceptions for special education expenses, historically a major financial challenge, indicates improving finances for many districts. Also, the elimination of exceptions related to construction projects corresponds to a credit-positive decline in key debt metrics. Districts can seek Act 1 exceptions to increase taxes for three purposes: special education, construction projects and pension obligations.

State aid increases and growing local property tax bases since 2015 have boosted revenue and districts' reserves and liquidity. The flexibility reserves provide serves as a buffer in the current economic climate, but districts having to tap reserves would be credit negative.

There are pockets of weakness in the sector and impending challenges from the coronavirus — including the state's projected $4 billion budget gap in fiscal 2021 and a proposal to keep the state's Basic Education Subsidy and Special Education Subsidy flat for the first time in five years. Commonwealth revenue is down 8% year to date for fiscal 2020.

Notably, applications for exceptions to the Act 1 index limit were due in February prior to the implementation of coronavirus-related school closures. With a later due date, requests to pierce the Act 1 cap may have been higher considering the proposed flat state aid in fiscal 2021.

Utilizing reserves to cover increases in expenses would be credit negative. The use of reserves could be driven by declining property valuations or property tax delinquencies, in addition to a drop in aid from the commonwealth. The receipt of Coronavirus Aid, Relief and Economic Security (CARES) Act funding will help, though school district funding will carry a degree of uncertainty at least well into 2022 as the state copes with the coronavirus effects on its budget. Among the 20 largest districts we rate that are receiving CARES Act funding, none will receive funding amounts topping the equivalent of 4% of general fund revenue and the funds can only be used to cover expenses related to the pandemic and not to close budget gaps.

Endnotes

1 The Act 1 index limits a school district's ability to raise property taxes to a level prescribed by the Pennsylvania Department of Education. Among the considerations are the average percent increases in the statewide average weekly wage and the federal employment cost index for elementary/secondary schools. Exceptions sought by districts are rarely, if ever, denied by the state.

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Top servicers’ absence from NextGen Direct Loan servicing contract is credit negative

On 24 June, the US Department of Education announced the five companies awarded contracts to service the federal Direct Loan Program (DLP) through the NextGen centralized servicing platform, and the three largest federal student loan servicers - Nelnet, Inc. (Ba1 review for downgrade), Navient Corporation (Ba3 negative) and Pennsylvania Higher Education Assistance Agency (PHEAA) - will not participate.

The three servicers’ absence from the contracts is credit negative for the Federal Family Education Loan Program (FFELP) and private student loan (PSL) asset-backed securities (ABS) they service, even though securitizations will not be part of the NextGen platform.

As Nelnet, Navient and PHEAA redirect resources to portfolio migration, the FFELP and PSL deals they service may face indirect risks. The three companies serviced more than 85% of the $1.2 trillion in DLP and Education Department-owned FFELP loans as of 31 March 2020 (see exhibit), and they will have to transfer accounts for about 28 million borrowers to other providers in a few years, a considerable and complex undertaking.

Student loan servicer portfolio sizes
Includes DLP and Education Department-owned FFELP loans, as of 31 March 2020

Servicer	Portfolio, dollars outstanding (billions)	Recipients (millions)	% of total outstanding portfolio by dollars
Nelnet-Great Lakes	456.4	14.1	38.05%
AES-PHEAA	374.3	7.9	31.21%
Navient	229.7	6.1	19.15%
Not-for-profit Servicers	139.0	7.4	11.59%
Total	1,199.4	35.5	

Nelnet and Great Lakes portfolios are merged into one row because Nelnet acquired Great Lakes in February 2018. AES is American Education Services.
Source: National Student Loan Data System

While the portfolio migration does not directly affect the three servicers' FFELP and PSL portfolios, which are serviced on separate platforms from DLP loans, it could still expose the ABS to indirect risks. Moving accounts will prompt the servicers to reduce their business scale and staff, creating operational difficulties by decreasing their ability to accommodate spikes in servicing volume and potentially compromising institutional knowledge. If the companies direct resources to the portfolio migration that they would otherwise invest in process improvements for their ABS portfolio, it could affect the servicing quality. In addition, a large increase in servicing volume could affect resource allocation for the five newly selected servicers, which also service ABS, and diminish their focus on the existing servicing portfolio during the DLP servicing ramp-up.

The contract loss will weaken servicers' ability to provide ABS liquidity. Following the announcement, we changed our outlook on Navient to negative from stable and placed Nelnet’s rating on review for downgrade, partly reflecting their different rating levels. Although servicing federal DLP loans is only a modest contributor to either company's current profitability, the contract provides scale, insight and relationships in their core student loan business services offerings. In addition, the companies face operational challenges as well as potential litigation risks in transferring their almost $750 billion of DLP servicing.

Without the DLP servicing contract, the servicers’ financial strength weakens and their ability to provide liquidity support to certain FFELP ABS that they sponsor also declines. FFELP deals with insufficient collections to repay investors by final maturities are subject to payoff risk. Because of slow repayment rates, FFELP deals issued before 2016 have remaining maturity risk. FFELP transaction sponsors have provided liquidity to prevent certain transactions from defaulting.[1]

If the sponsor-servicer's ability to provide such liquidity on a timely basis is reduced, noteholders are less likely to be repaid at the notes' legal maturities. FFELP deals issued on or after 2016 have lower exposure to maturity risk because the notes typically benefit from long-dated maturities and turbo features that use excess collections to accelerate payments to the notes after a certain date.

The risk of a major servicing disruption to ABS is low. The degree of financial impairment for these servicers is likely to be limited. All companies will continue to be large student loan servicers even after the transfer of the DLP loans. As of March 2020, Navient owned approximately $84.8 billion of FFELP and PSL. Meanwhile, Nelnet serviced about $48.7 billion in FFELP, PSL and consumer loans, of which they owned about $21.1 billion.

The NextGen transition will likely take several years, deferring risks to a future date. The Education Department still has to award a servicing system contract before any transition can occur. All three servicers' current servicing contracts expire in December 2020, with two potential six-month extensions at the Education Department's discretion through December 2021.

Endnotes

1 For example, Navient amended some deal documents to include an option for the sponsors to purchase an additional 10% of the trusts' initial pool balance or enable trusts to borrow money from Navient Corporation on a subordinated basis through a revolving credit facility to pay off the notes or both. Similarly, Nelnet can optionally redeem notes as early as 2022 in addition to its 10% cleanup calls.

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CREDIT IN DEPTH

Financial conditions for most emerging markets stabilise, but pandemic weighs on second-half credit prospects

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» **Financial conditions are normalising across most major emerging market (EM) countries.** Our new series of proprietary EM Financial Conditions Indicators (FCIs) signal a gradual stabilisation in financial conditions for most major emerging markets – the G-20 emerging market countries, comprising Argentina, Brazil, China, India, Indonesia, Mexico, Russia, Saudi Arabia, South Africa and Turkey. These countries accounted for 69% of emerging market gross domestic product globally (in PPP international dollar terms) and 79% of non-sovereign EM eurobond issuance in 2019. Capital flows, equity markets, bond spreads and (to a lesser degree) economic sentiment have begun to calm. As market conditions settle, most major EM countries will avoid serious balance-of-payments crunches, making it easier for rated EM debt issuers to access dollar liquidity and return to the primary markets.

» **But the pandemic-induced shock to growth, earnings and debt burdens will increase EM credit vulnerabilities**. Still-elevated rates of coronavirus infections and fatalities will complicate the reopening of domestic economies. Even as governments relax containment measures, the legacy of lost economic output will be higher government debt burdens and corporate leverage. The pandemic may accelerate the trend toward a more splintered and protectionist global economy, weighing on EM trade prospects well after lockdowns ease.

» **The pandemic is amplifying structural weaknesses in sovereign credit profiles**. The crisis is reinforcing a gradual erosion of credit quality for some major EM sovereigns that had already been occurring for several years. Countries with stronger external and public balance sheets, or that exhibit credible policy responses, are better positioned to ride out and recover from the current downturn.

» **Credit stress among speculative-grade EM companies may further hold back economic recovery**. Of the 731 EM nonfinancial companies we rate, about one-third carry a negative bias and, of these, 83% are below investment grade. Even with improved market sentiment, credit stress among speculative-grade EM companies is likely to persist, raising the spectre of higher defaults.

» **Systemic risks will likely remain contained for most EM banks**. Capital flight and currency depreciation have triggered EM banking crises in the past. This time around, most EM banking systems, except Turkey's, are not dependent on short-term wholesale funding in foreign currency. Asset quality and profitability will inevitably decline, but capital buffers provide a robust first line of defence. We also expect government support for systemically important banks in the event of severe distress.

Click here for the full report.

CREDIT IN DEPTH

Strains on US small and midsize businesses are credit negative for issuers across sectors

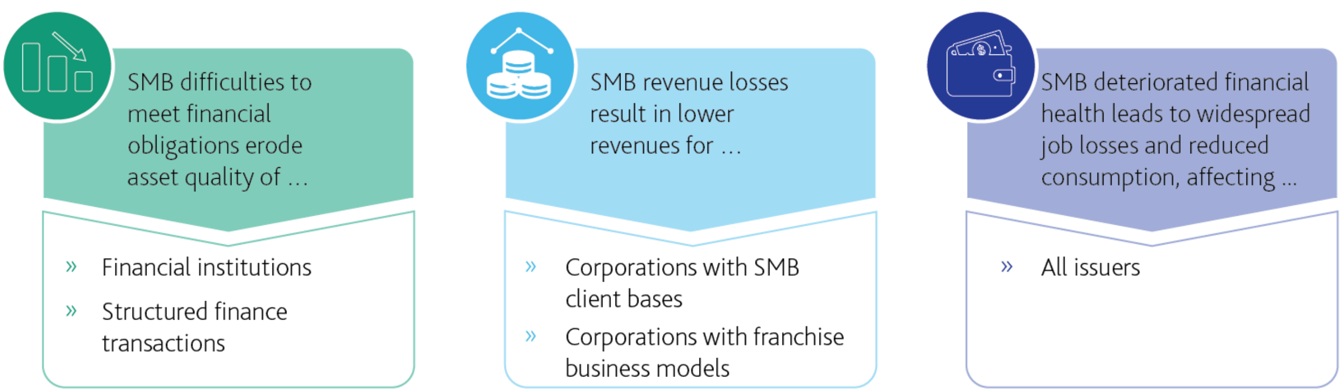
Originally published on 30 June 2020

Summary

The unprecedented depth and breadth of the coronavirus-triggered recession has put immense financial strain on small and midsize businesses (SMBs). While we largely do not directly rate this universe of companies, SMBs account for a significant share of US employment and economic activity. Therefore, their financial deterioration is reverberating across the economy and adding to the difficulties of issuers across multiple sectors.

- **SMBs' financial difficulties will affect a wide range of financial institutions.** Banks, which are the primary source of financing for SMBs, will experience some deterioration in asset quality and profitability related to these exposures.Earnings of non-banks will also take a hit, as these institutions play a growing role in SMB financing.
- **SMBs' financial hardship will contribute to a rise in delinquencies and charge-offs in certain structured finance transactions.** SME asset-backed securities (ABS), middle market collateralized loan obligations (MML CLOs) and commercial mortgage-backed securities (CMBS) are partially or entirely backed by SMB obligors.
- **Companies with SMB client bases or franchise business models will incur revenue declines.** The problems confronting SMBs will affect certain corporate issuers in the business services sector, as well as large lodging and restaurant chains that rely on a network of franchises.
- **Federal government support for SMBs will mitigate but not eliminate credit risk for exposed sectors.** Such programs provide short-term liquidity relief to SMBs but are insufficient to offset revenue losses resulting from pandemic-related disruption.

SMB struggles affect credit through three channels



Source: Moody's Investors Service

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» Kantar Global's term loan add-on improves liquidity

» Tesco's new Aldi price-matching campaign will likely spark credit negative sector price wars

» Bouygues Telecom's acquisition of Euro-Information Telecom is credit positive

» Indian Oil's inventory losses and weak refining margins lower fiscal 2020 earnings

» Qantas' equity raise and restructuring are credit positive

Infrastructure

» Avangrid's New York utility rate settlement is credit negative despite strong customer relations

» Ofgem decision on National Grid's coronavirus-related balancing charges is credit positive

Fintech

» Brazilian regulators halt Facebook's payments service, a blow for participating institutions

» For digital bank Banco Modal, Credit Suisse's investment is credit positive

» Banorte will expand digital services with Rappi partnership

Banks

» All large US banks pass Fed's stress test, but must submit new capital plans to reflect coronavirus

» Brazil adds new measures to stimulate bank loans to small and midsize enterprises

» Brazil's central bank reinforces small and midsize banks' liquidity and capital

» Plan to end Slovak bank levy is credit positive

» Russia's lower risk weights for mortgages aim to support loan origination

Sovereigns

» South Africa's GDP and revenue contract, spiking debt and making 2023 stabilisation unlikely

CREDIT IN DEPTH

» ASEAN-5 responses mitigate COVID-19 economic damage but are unlikely to offset rising credit risk

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