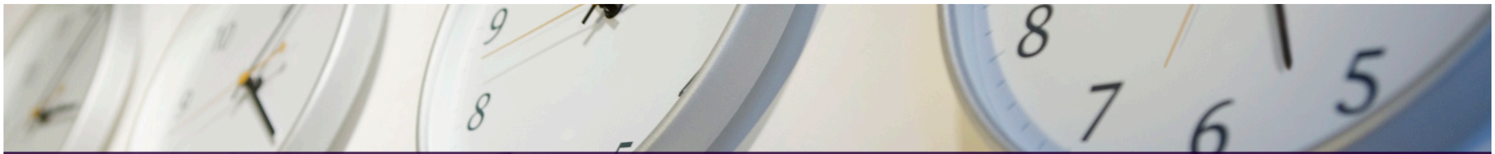

Credit Outlook

27 July 2020

NEWS AND ANALYSIS

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eBay's classifieds sale will reduce revenue, but high-margin businesses will help pick up slack

Originally published on 23 July 2020

On 21 July, eBay Inc. (Baa1 stable) announced plans to sell its online classifieds business, a collection of 12 brands in 13 countries, for roughly $9.2 billion to Adevinta ASA, a global online classifieds specialist based in Norway. eBay will receive $2.5 billion in cash, plus roughly 540 million Adevinta shares, representing a 44% equity stake in the business, including 33.3% voting shares.

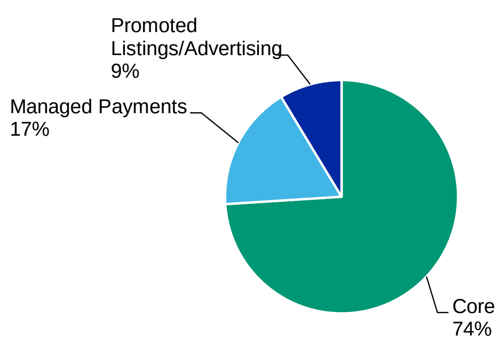
The sale is credit negative for eBay because it will reduce its revenue and operating scale and place more focus on its core marketplace business. After the sale, and the divestiture of StubHub earlier this year, eBay's core marketplace operations will effectively generate all of the company's revenue, versus 90% prior to the transaction. eBay's core marketplace is experiencing double-digit revenue growth so far this year, but top-line gains have historically lagged those for e-commerce overall.

The classifieds business generated $1 billion of revenue for the 12 months that ended March 2020, with 39% segment margins, compared to 33% for eBay's core marketplaces. It represents about 10% of eBay's total revenue, and roughly 12% of segment margin contribution. The business will likely post double-digit percentage revenue declines for the first half of 2020 due to weak advertising demand, particularly for auto verticals, driven by stay-at-home orders related to COVID-19 and the global recession.

The loss of the classifieds business will be partially offset by the eBay's 44% equity stake in Adevinta, which upon the transaction's closing will become the largest online classifieds company in the world. The stake will provide eBay with an alternate source of liquidity in the form of publicly traded shares that it could sell if it needed to raise cash. Combining eBay's classified business with Adevinta will also generate estimated annual synergies of $150-$185 million within three years.

Over the next two years, incremental revenue and cash flow from two newer, high margin businesses – managed payments and promoted listings -- will also help offset the loss of classifieds revenue (see exhibit). Collectively, these businesses provide more seller tools, improve buyer experiences, and leverage structured data to improve results with filtered search. eBay is on track to generate an incremental $2 billion of revenue and $500 million of operating income in 2022 through its emerging managed payments business. eBay has also been successful growing advertising revenue through high-margin promoted listings, which the company expects will be the vast majority of the projected $1 billion in annual ad revenue over the next couple of years.

Newer businesses will help offset the loss of classifieds
Projected revenue streams for 2022



Source: Moody's Investors Service estimates eBay's core marketplace business has demonstrated operating momentum following investments to leverage its data content and improve the format of its various sites aimed at enhancing the discovery-based user experience. More recently, the impact of COVID-19, stay at home orders, and social distancing measures in most countries accelerated active buyer growth for eBay with 6 million new and reactivated buyers added in April and May. The number of sellers has also increased with the addition of tens of thousands of small businesses.

We estimate that the divestiture will increase eBay's pro forma adjusted leverage to roughly 2.7x debt/EBITDA compared to an expected 2.5x as of December 2020, including repayment of $500 million of notes due November 2020 with cash raised from an earlier debt issuance. We expect leverage will return to pre-transaction levels less than one year after closing, based on EBITDA growth, or sooner if eBay uses a portion of cash proceeds to reduce debt balances. We believe eBay will use the $2.5 billion of cash proceeds in accordance with its stated financial policy of balancing the interests of both creditors and shareholders while keeping reported leverage at about 1.5x net debt/EBITDA and below 3.0x gross debt/EBITDA.

We expect eBay will use a portion of net cash proceeds to fund shareholder returns. eBay initiated a quarterly dividend of 14 cents (roughly $500 million annual payout) at the beginning of 2019 and repurchased $4 billion of common stock in the first quarter of 2020, largely with net proceeds from the sale of StubHub for just over $4 billion. Management's commitment to balanced capital allocation is crucial given equity investments in eBay over the last two years by activist investors Elliott Management (over 4% of eBay's shares) and Starboard Value (less than 2%).

eBay's disciplined financial policies are also critical to the managed payments business and the company's new role as a payments intermediary between its sellers and buyers. Beyond the near-term, eBay could potentially use cash proceeds from the sale of a portion or all of its equity interest in Adevinta to acquire businesses that enhance its existing core marketplace platform while maintaining its long-term leverage targets.

The companies expect to close the transaction in the first quarter of 2021, subject to regulatory approvals and other customary closing conditions, as well as approval by two-thirds of Adevinta ordinary shareholders. Following the close, eBay will be entitled to designate two directors to the Adevinta board so long as it holds at least 25% of the Adevinta ordinary voting shares (eBay will have just over 33.3% of voting shares at close), and one director so long as it holds at least 10% of the Adevinta ordinary voting shares.

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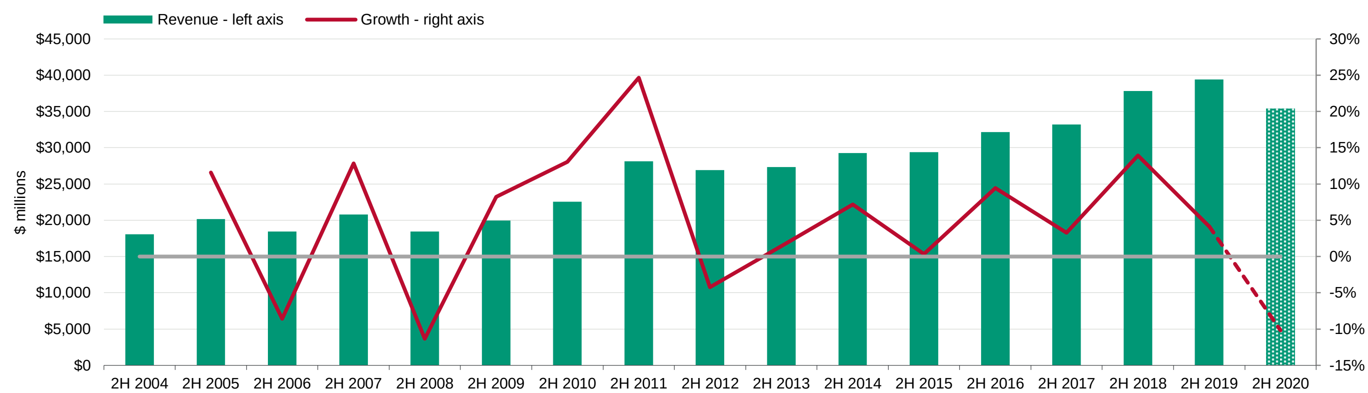
Intel reports strong quarterly results, but weak guidance and production delays are credit negative

Originally [published](#) on 24 July 2020

On 23 July, semiconductor maker Intel Corporation (A1 stable) reported a 20% year-over-year increase in revenue to $19.7 billion, well above the $18.5 billion level the company guided to three months ago. Intel also guided to a record $75 billion of full year revenue and a record $17.5 billion of cash flow after capital spending. Notwithstanding the strong full year outlook, the outlook is credit negative as it implies a year-over-year revenue decline of 10% in the second half of the year, the largest such decline since revenue fell by 11% in the second half of 2008 (see Exhibit 1).

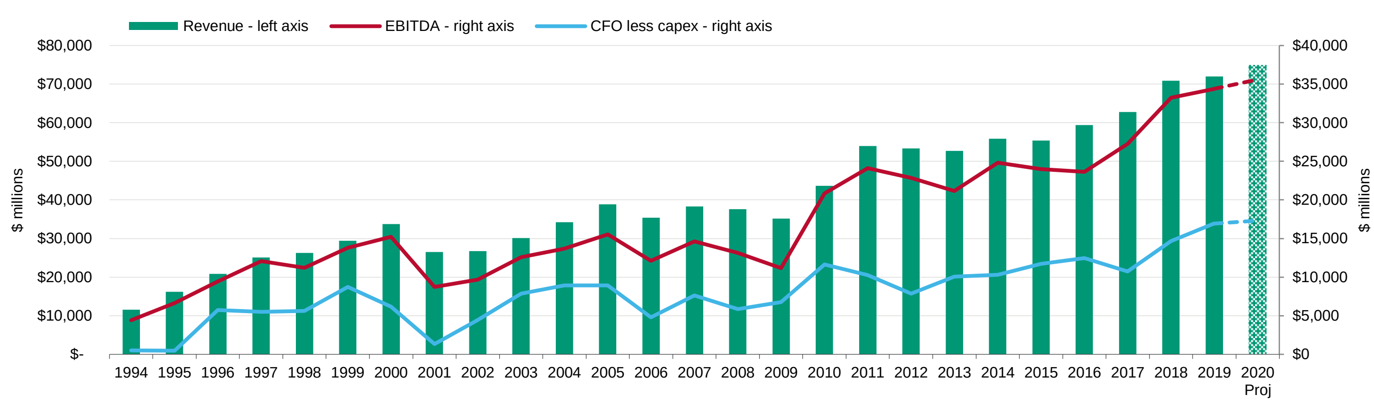
Exhibit 1
Second-half revenue and growth



Sources: Moody's Financial Metrics™ and Moody's Investors Service projections

With EBITDA (we project $36 billion), cash flow after capital spending ($17 billion), and free cash flow ($12 billion) likely setting records again this year (see Exhibit 2), Intel nonetheless remains challenged to maintain near-leading edge manufacturing and process technology, after having ceded that to the world's leading foundry, [Taiwan Semiconductor Manufacturing Co. Ltd.](#) (TSMC, Aa3 stable) a few years ago.

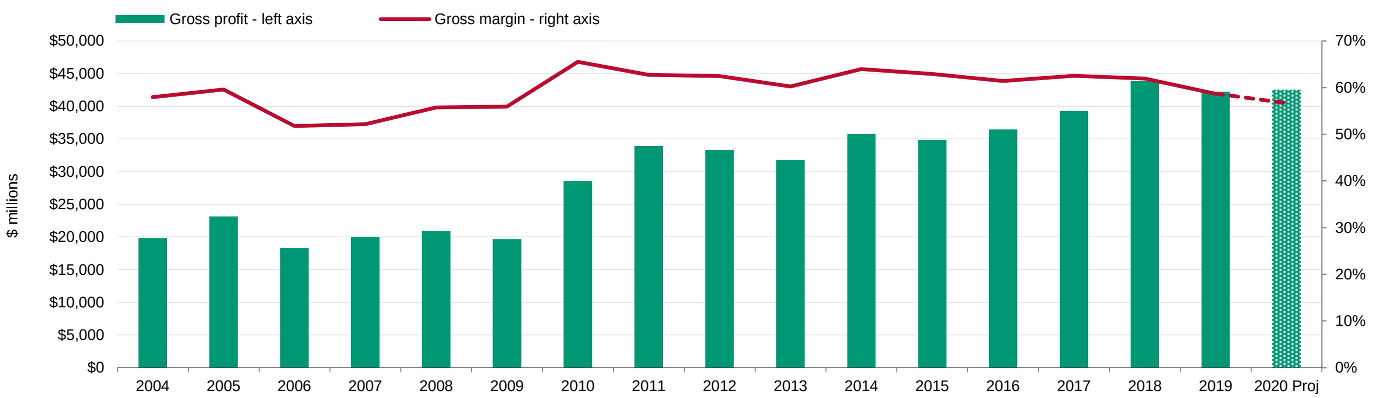
Exhibit 2
Revenue, EBITDA and cash flow after capital spending still setting records in 2020



Sources: Moody's Financial Metrics™ and Moody's Investors Service projections

Intel noted that while it is making belated progress in ramping production using 10 nanometer (nm) process technology, manufacturing costs will remain higher in the still early part of this technology, which, among other items, will contribute to lower gross margins over the next two quarters. We project gross profit dollars are critical to covering steady and high research and development expenses, gross margins are indicative of a competitive products and manufacturing efficiency, and we anticipate gross margins will fall to their lowest level since 2006 (see Exhibit 3).

Exhibit 3
Gross margin under some pressure

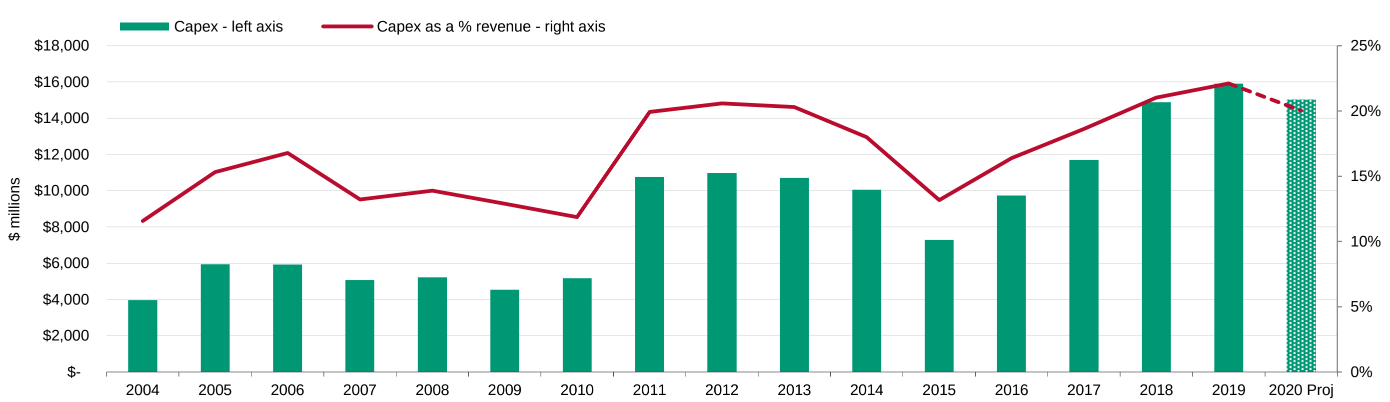


Sources: Moody's Financial Metrics™ and Moody's Investors Service projections

Moreover, the company announced that its progress in moving to 7nm production nodes will be delayed by at least 6 months and noted that its first 7 nm product would be a client microprocessor in late 2022 or early 2023. We note that the 7nm delay follows the delay of 10nm, which was initially targeted for the second half of 2017 and is just now ramping into high volume today, about 3 years later. The ongoing delays are disruptive to the longer term planning process, hurt Intel's credibility with customers who need to rely on effective semiconductor technology roadmaps in volume production in order to plan for their products, and open the door further for Advanced Micro Devices, Inc. (Ba2 positive) to gain market share, particularly in servers.

Importantly, as Intel confronts these process node and manufacturing challenges, the company noted a willingness to outsource some leading edge production capacity as a "contingency plan", potentially leading to a more fab-light model over several years. Intel's long term technology process node and manufacturing leadership (that has clearly waned over the last few years) comes at the cost of significant capital spending (see Exhibit 4). Intel's key competitors - Advanced Micro Devices, Nvidia Corp. (A3 positive), and Xilinx Inc. (A3 stable) - all use foundries, which allows them to allocate more capital to research and development efforts.

Exhibit 4
Capital spending will remain high



Sources: Moody's Financial Metrics™ and Moody's Investors Service projections

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Walmart's potential sale of Asda subsidiary is credit positive for UK grocers

Originally published on 23 July 2020

Citing a company spokesman, various media sources including the Financial Times on 20 and 21 July reported that US retail giant Walmart Inc. (Aa2 stable) had resumed talks to sell UK grocer Asda Group Ltd. Walmart has not made a public statement confirming or denying the reports. In the event Walmart sells all of its wholly owned subsidiary, it would be credit positive for the UK's other large incumbent grocery retailers because we do not expect any new owner to have the same financial strength or bargaining power as Walmart. As a result Asda would be less aggressive in competing for market share, helping competitors preserve their EBITDA margins.

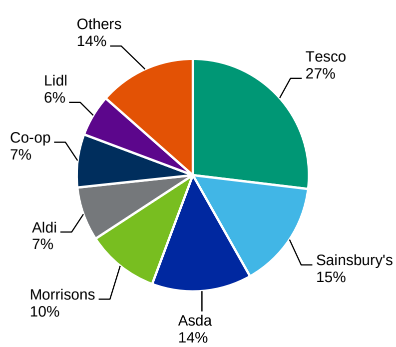
If Walmart retains a portion of Asda, thus keeping a vested interest in its continued success, the benefits to other competitors would be more muted depending on the duration of Walmart's continued ownership.

A divestiture of Asda, which is clearly Walmart's intent, continues the company's international repositioning strategy. It has heightened its focus on faster growing markets such as China and India and has already exited Brazil. During the past decade, Walmart has taken meaningful steps to improve Asda's market share through price investments. This has met with mixed success as its market share continued to decline along with that of the other largest UK grocers. A new owner with lesser financial strength than Walmart would probably be less competitive on price and choose a different strategy. A potential sale to a private equity firm, similar to its sale of Brazil to Advent, would likely result in a highly leveraged capital structure, which could limit Asda's ability and willingness to lower its prices to take market share away from peers.

There are other possible outcomes, such as a stock market listing or a sale to an existing smaller competitor or another trade buyer not yet present in the UK. However we do not think any of these outcomes would significantly alter the very competitive dynamics of the UK grocery sector.

Asda is the third-largest supermarket in the UK with revenue of around £23 billion and a market share of around 13.9% as at mid-June, according to Kantar Worldpanel, an industry consultant. As Exhibit 1 shows, the UK grocery market is very fragmented. As well as the "big four" grocers Tesco PLC (Baa3 stable), J Sainsbury plc and Wm Morrison Supermarkets plc (Baa2 stable) the market includes the two German discounters Aldi and Lidl, several other supermarket chains and independents.

UK grocery market is highly fragmented
UK grocery market shares for the 12 weeks ending 12 July 2020



Source: Kantarworldpanel

We do not think the competition authority will allow any of the other three big UK grocers to buy Asda, based on a recent precedent. In 2019 the Competition and Markets Authority (CMA) blocked the proposed merger of Asda and Sainsbury's. The CMS said the merger would reduce competition and service on a national and local level and leave customers paying more.

The "big four" all focus on traditional supermarket formats based on large stores with multiple selections for each product, chains of smaller convenience stores and online delivery. Despite this format diversification, product price competition is very high and is exacerbated by smaller competitors and discount stores. In June, Tesco extended a campaign to match prices with Aldi to a wider range of products. Tesco has scale and should benefit from its renewed focus on keeping prices and costs low, but smaller UK grocers will probably struggle. The strategy of US online retail giant Amazon.com Inc. (A2 positive) in the UK remains unclear but its presence through a partnership with Morrisons adds to what is already very intense sector competition.

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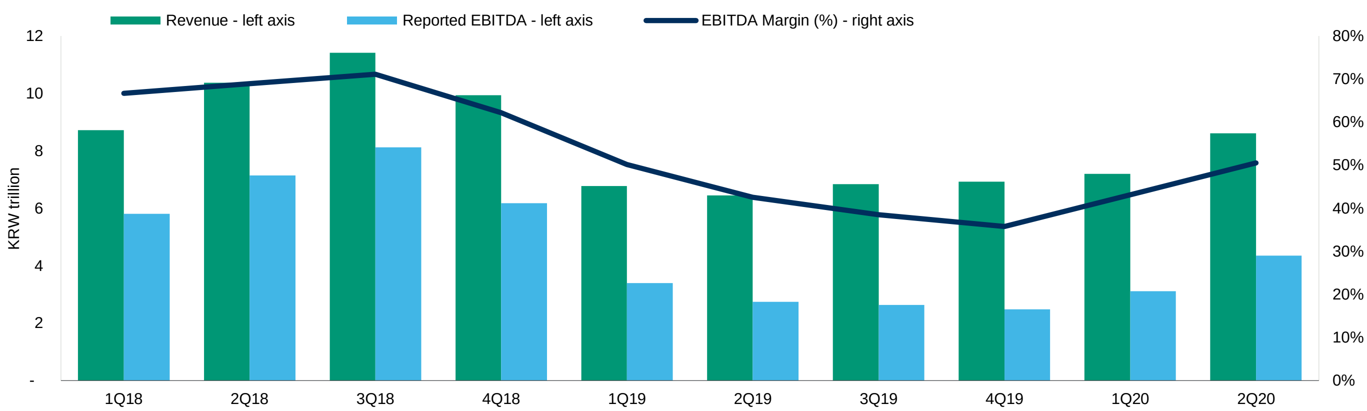
SK Hynix's improved second-quarter results are credit positive

Originally published on 23 July 2020

On 23 July, SK Hynix Inc. (Baa2 negative) reported a 40% quarter-on-quarter improvement in its EBITDA, as measured by the company, for second-quarter 2020. The strong results are credit positive for SK Hynix because it signals improvement in the global memory-chip industry after a significant weakening in 2019. This growth, if sustained, will allow the company to improve its currently elevated leverage metrics. However, its Baa2 issuer rating and negative outlook remain unchanged because of the uncertainty of its debt reduction.

The Korean memory-chip producer's reported EBITDA improved to KRW4.4 trillion in second-quarter 2020 from KRW3.1 trillion a quarter earlier (or KRW2.7 trillion a year earlier) as a result of a 20% quarter-on-quarter increase (33% year on year) in revenue (see exhibit). The strong revenue growth was driven by solid improvement in the selling prices of memory chips and moderate growth in bit shipment.

SK Hynix's earnings rebounded in second-quarter 2020



Source: SK Hynix

The gains in prices and shipment volumes mainly reflect strong demand for dynamic random access memory (DRAM) from server customers. The server companies ramped up their investment during first half 2020 as the increasing teleconferencing and media streaming boosted data consumption. The solid demand for server DRAM more than offset the lackluster demand from smartphone producers.

We estimate that profitability in the company's NAND division also improved, thanks to a better sales mix. SK Hynix ramped up its shipment of solid-state drives (SSD) to close to half of its total NAND sales in second-quarter 2020, from around 20% a year earlier. The demand and pricing for SSDs have been relatively strong amid the coronavirus outbreak, compared with weak demand for NAND used in smartphones and consumer electronics.

We expect demand for server DRAM, the key driver of improvement in second-quarter 2020, will moderate during second half 2020, as server companies adjust their inventory levels. However, we expect overall industry conditions to remain strong compared with weak 2019 levels because of recovery in demand from smartphone and game console producers with the expected major product launches, including 5G phones and flagship consoles.

The company's reported debt stood at KRW12.7 trillion as of 30 June 2020, which is slightly higher than KRW12.4 trillion three months earlier. However, the company's cash holdings also increased by KRW522 billion to KRW5.3 trillion during the period because a reduction in capital spending and better earnings more than offset the annual dividend paid in the second quarter.

Improving industry fundamentals mean that we expect the company's financial metrics to improve over the next 12 months. However, there is some uncertainty over the pace of improvement, as the company's ability to generate positive free cash flow and reduce debt are subject to containment of capital spending and a sustained industry recovery.

SK Hynix's adjusted debt/EBITDA was 1.1x and debt/capitalization 20.3% in 2019, which were weak for its current underlying credit quality. The company's Baa2 rating incorporates a one-notch uplift from its underlying credit quality based on the likelihood of parental support from SK Telecom Co., Ltd. (A3 negative).

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POSCO's weak second-quarter results are credit negative

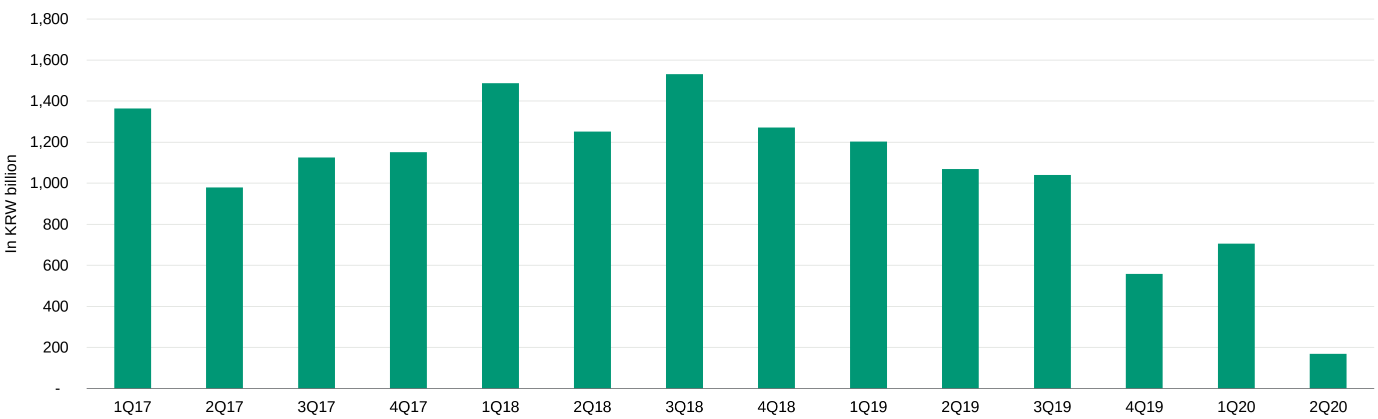
Originally published on 22 July 2020

On 21 July, POSCO (Baa1 stable) reported a 84% year-on-year decline in its operating profit for second quarter 2020. The weak results, although expected, are credit negative because they highlight the difficult operating environment for the company's core steel business.

The results will not immediately affect its ratings or outlook because we expect the company to maintain a solid capital structure despite weak earnings.

The Korean steelmaker's consolidated operating profit fell sharply to KRW168 billion in second-quarter 2020 from KRW1.1 trillion a year earlier as its core steel business fell to a loss. POSCO's steel revenue was down 22% year on year (see exhibit), reflecting declines in both sales volumes and selling prices amid a coronavirus-induced demand shock. The weak demand for auto sheets was particularly negative for POSCO's profitability because of its large exposure to this segment and the high margins on such products.

POSCO's operating profit dropped sharply in second quarter 2020



Preliminary results for second-quarter 2020. Figures are on a consolidated basis.
Source: Company presentation

The combined operating profit of POSCO's non-steel businesses was KRW304 billion, which is largely similar to a year earlier. The stable non-steel results helped to keep POSCO's consolidated operating profit positive.

Steel demand is likely to gradually improve during the remainder of 2020 as industrial activity resumes. However, we expect the absolute level of demand will remain sluggish because of a likely protracted period of economic recovery. Furthermore, steelmakers such as POSCO are likely to find it difficult passing on the elevated raw material costs to customers because of weak end-markets.

Despite the earnings decline, POSCO maintains a solid capital structure and high financial flexibility. Its reported net debt (consolidated) decreased to KRW7.3 trillion at the end of June 2020 from KRW8.2 trillion three months before.

We expect POSCO's balance sheet to be solid over the next 12 months; we expect that the company will remain prudent with the execution of capital spending and management of working capital. Consequently, we expect its adjusted net debt/EBITDA to peak at around 2.0x in 2020, up from 1.3x in 2019, before moderating toward 1.5x in 2021-22. The projected net leverage for 2021-22 is consistent with POSCO's Baa1 rating level.

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Goldman Sachs settlement with Malaysia reduces uncertainty, but DOJ investigation remains open

Originally published on 24 July 2020

On 24 July, The Goldman Sachs Group, Inc. (GS, A3 stable) announced that it had reached an agreement to resolve all proceedings in Malaysia relating to the firm's involvement with 1Malaysia Development Berhad (1MDB). The agreement does not involve pending investigations in other jurisdictions, most notably by the US Department of Justice (DOJ). Nonetheless, we believe the settlement is credit positive because it reduces the risk that fines or penalties in connection with 1MDB will weaken the firm's capital position or credit profile.

The agreement includes a $2.5 billion payment to the Government of Malaysia and a guarantee that Malaysia receives at least $1.4 billion in proceeds from assets seized by governmental authorities around the world. We do not expect the guarantee will require any payment by GS unless the value of the assets deteriorates significantly. Over the last 2 ½ years GS has accrued more than $3.2 billion of provisions for litigation and regulatory proceedings, most of which we believe are related to the 1MDB matter. We therefore do not expect the settlement with Malaysia will have any impact on the firm's earnings or capital.

Even with this agreement reached, GS disclosed that it expects to materially increase its provisions for litigation and regulatory proceedings for the second quarter of 2020, likely reflecting an increased probability of a settlement with the DOJ and other authorities. No amount was disclosed, but it will be reflected in GS's 10-Q filing, which should be made public by the first week of August.

A settlement with the DOJ would likely be under the Foreign Corrupt Practices Act (FCPA). The largest penalty ever assessed under the FCPA was $2.0 billion against Airbus earlier this year, although the amount paid by Airbus to US authorities was substantially lower because the DOJ credited toward payment the amounts Airbus paid to French authorities. The next two largest amounts paid to the US under FCPA settlements (including disgorgement) were roughly $1.1 billion each (Petrobras in 2018 and Ericsson in 2019).

We expect GS will increase its provisions for litigation and regulatory proceedings for Q2 2020 by between $1.5 and $2 billion, raising the firm's total litigation provisions over the past 2 ½ years to between $4.7 and $5.2 billion. If none of these provisions were used for other matters, this would leave between $2.2 and $2.7 billion to cover its liability to the DOJ and other US authorities after making its payment to Malaysia, more than twice what any other firm has paid to the US under the FCPA. Last week GS reported net income after tax for Q2 2020 of $2.4 billion. Even assuming none of the additional provision is tax-deductible, we expect GS would still report a modest second quarter profit.

If this additional provision allows GS to fully absorb its eventual settlement with the DOJ without incurring any impairment to its capital position, it will be credit positive. However, additional litigation accruals cannot be ruled out until a settlement is reached.

The settlement with Malaysia does not include any requirement that the company plead guilty to a criminal charge, which is notable because a criminal plea can lead to a loss of licenses in certain jurisdictions unless waivers are obtained. A plea could also lead to the loss of clients, especially government or institutional clients with policies that prohibit them from doing business with a convicted felon.

There remains the possibility that the DOJ could require a guilty plea to a criminal charge as a part of its settlement. If this occurs, it would be credit negative, but we expect that GS will be able to obtain the necessary waivers to avoid any loss of licenses or authorities.

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Hurricane Douglas heads toward Hawaii, threatening losses for P&C insurers

Originally published on 26 July 2020

On 26 July, Hurricane Douglas, currently a Category 1 storm, was moving toward the main Hawaiian Islands, potentially bringing damaging winds, storm surge and flash flooding from heavy rainfall. Although it is unclear whether the hurricane will make landfall or not, the aftermath could be significant and cause the loss of life, property damage and displacement of people.

Based on the insurance premium concentration in Hawaii, Exhibits 1 & 2 show the top ten primary insurers that Douglas would likely affect. Primary insurers including State Farm Mutual Automobile Insurance Company, United Services Automobile Association (Aaa negative), The Allstate Corporation (A3 stable), Liberty Mutual Group Inc. (Baa2 stable) and American International Group, Inc. (Baa1 stable) would probably be less affected because their premium concentration in Hawaii is modest. Based on careful monitoring of their exposures, geographic diversification, high-quality reinsurance protection and strong capital bases, we believe these large national carriers can withstand a hurricane event in Hawaii. Regional insurers, however, would take a bigger hit because of their geographic concentration.

Exhibit 1
Top 10 homeowners' insurers in Hawaii, 2019

Company	Hawaii direct premiums written ($ millions)	US direct premiums written ($ millions)	Premium concentration in Hawaii	Surplus ($ millions)
State Farm	$127	$18,978	0.7%	$116,232
Heritage Insurance [2]	$53	$803	6.6%	$352
First Insurance [3]	$42	$42	100.0%	$266
USAA	$29	$6,836	0.4%	$30,476
Allstate	$25	$8,723	0.3%	$19,887
DB Insurance	$22	$25	88.8%	$113
Liberty Mutual	$18	$6,861	0.3%	$20,539
Island Insurance	$17	$17	100.0%	$125
RLI Corp.	$13	$16	81.8%	$1,030
American International Group	$12	$1,104	1.0%	$17,439
Total	**$357**	**$43,404**	**0.8%**	**$206,459**

[1] According to the Hawaii Department of Commerce and Consumer Affairs, hurricane insurance is a supplemental coverage to homeowners policies that provides wind-related damage. As part of the mortgage approval process, banks require homeowners to have insurance.
[2] Heritage Insurance Holdings, Inc. is the parent company of Zephyr Insurance Company, Inc., a residential wind-only property insurer in Hawaii.
[3] First Insurance Company of Hawaii, Ltd. is a subsidiary of Tokio Marine Holdings Inc.
Sources: SNL Financial L.C. (contains copyrighted and trade secret materials distributed under license from SNL, for recipient's internal use only) and Moody's Investors Service

Exhibit 2

Top 10 commercial property insurers in Hawaii, 2019

Company	Hawaii direct premiums written ($ millions)	US direct premiums written ($ millions)	Premium concentration in Hawaii	Surplus ($ millions)
First Insurance [1]	$42	$81	51.6%	$266
American International Group	$36	$3,731	1.0%	$17,439
Allianz	$33	$1,828	1.8%	$1,728
DB Insurance	$27	$81	33.6%	$113
Liberty Mutual	$24	$6,285	0.4%	$20,539
Continental Casualty	$20	$4,445	0.5%	$10,787
Zurich American	$18	$2,555	0.7%	$7,673
Geovera	$17	$78	21.3%	$93
ACE American	$16	$4,037	0.4%	$17,646
Centauri Specialty	$15	$46	32.3%	$23
Total	**$247**	**$23,167**	**1.1%**	**$76,308**

[1] First Insurance Company of Hawaii, Ltd. is a subsidiary of Tokio Marine Holdings Inc

Sources: SNL Financial L.C. (contains copyrighted and trade secret materials distributed under license from SNL, for recipient's internal use only) and Moody's Investors Service

Primary property and casualty insurers may incur claims on high-value commercial (hotels and resorts, tourism and industrial) and residential properties, including watercraft, and private passenger and commercial vehicles. Apart from property damage, commercial lines claims would likely include business-interruption losses, which could be sizable if the hurricane disrupts critical infrastructure, causes long-term power outages or interrupts businesses.

The coronavirus and related economic downturn have severely affected Hawaii's travel and leisure sectors, complicating the calculation of potential business-interruption claims, which are generally designed to replace loss of income, and in turn increasing the number of potential disputes. In addition, such losses vary according to provisions in individual insurance contracts.

If heavy rain causes widespread flooding, economic losses could be significant. However, homeowners' policies typically do not cover flood damage. Homeowners located in a flood zone often obtain coverage from the government-backed National Flood Insurance Program, a division of Federal Emergency Management Agency (FEMA). In previous hurricanes, FEMA provided some disaster assistance, including repair or replacement of homes to uninsured and underinsured homeowners.

Flood damage often becomes a point of dispute when the immediate cause of loss (wind versus flood) is unclear. Commercial line insurers may face losses from flooding, which is typically an optional commercial coverage.

Douglas is a reminder of the Hawaiian Islands' exposure to hurricanes. Hawaii is not usually affected by tropical cyclones because of the high-pressure weather patterns over the central Pacific and a lot of deep, cool water surrounding the islands. The most powerful hurricane to hit Hawaii was Hurricane Iniki, a Category 4 storm that hit Kauai in 1992, according to AIR Worldwide, a unit of Verisk Analytics. If a hurricane like Iniki struck today, AIR estimates that insured losses would likely exceed $3 billion. If a storm as powerful as Iniki made landfall in Honolulu today, insured losses would be around 11x greater than those from Iniki.

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Genworth Financial's settlement with AXA is credit negative

Originally published on 24 July 2020

On 20 July, Genworth Financial Inc. (Genworth), the ultimate parent of Genworth Holdings, Inc. (Holdings, B3 developing), announced that it will incur a $516 million after-tax charge in the second quarter as part of a settlement in a dispute with AXA (A2 stable) over two companies AXA acquired from Genworth in 2015. The companies underwrote payment protection insurance that was allegedly mis-sold by a third party distributor. AXA has made payments to customers making mis-selling compliants. Genworth's $516 million charge includes a $125 million cash payment to AXA on 23 July 2020 and its issuance to AXA of a £317 million secured promissory note. The note stipulates two deferred cash payments after 2021 totaling approximately £317 million with the first payment in June 2022 and the second payment in September 2022.

The settlement strains Holdings' cashflow given the company's limited access to the debt capital markets and need to develop alternative financing arrangements. Genworth's secured promissory note reflects its challenges to build future liquidity at Holdings, and continuing delays to close its planned acquisition by China Oceanwide Holdings Group Co. Ltd., which was announced in 2016. The latest delay (so far, there have been 15 extensions of the merger agreement) was announced 30 June and reflects the difficulty in consummating the transaction amid the significant volatility in the global financial markets because of the coronavirus pandemic. Without China Oceanwide's acquisition of Genworth, the company will be challenged to extend its debt ladder amid limited dividends in 2020 from its insurance subsidiaries, relative to its debt load.

Alternate financing could include a potential debt offering, as well as an initial public offering of its US Mortgage Insurance business, absent a transaction with China Oceanwide, which includes a $1.5 billion capital investment plan.

Still, the settlement is a favorable development. It should improve the company's credit profile, and Genworth had material holding company resources of $575 million at 31 March 2020 to fund the initial July 2020 payment to AXA. Additionally, the settlement removes uncertainty about the amount of the liability with AXA and clears a hurdle so that Genworth can pursue alternative financing arrangements for its upcoming debt maturities of approximately $1.1 billion in 2021 and repay the note with AXA in the event the transaction with China Oceanwide does not materialize or is further delayed. Although the note issued to AXA was secured by Genworth pledging 19.9% of its outstanding shares in Genworth Mortgage Holdings Inc. (GMHI) (the intermediate holding company for the US mortgage insurance business) and Genworth MI Australia, it permits Genworth to pursue strategic alternatives to raise capital for near-term liquidity needs.

The AXA note's prepayment events and release of collateral are aligned with future alternatives to raise capital including from the US mortgage insurance business, and capital contributions tied to the China Oceanwide transaction are credit positive because the company expects proceeds from these actions to pay down Holdings notes due in 2021, and also facilitate the paydown of the AXA note.

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Coronavirus effects lead to large first-half losses for QBE Insurance

Originally published on 24 July 2020

On 22 July, QBE Insurance Group Limited (A3 stable)[1] announced that the coronavirus pandemic will have a negative impact on its first-half 2020 results, which are due to be announced on 13 August. We regard the coronavirus outbreak as a social risk under our ESG framework, given the substantial implications for public health and safety. The weak global economic outlook, falling oil prices, and asset price declines are creating a severe and extensive credit shock across many regions and markets including the insurance sector. While the breadth and severity of the shock is still uncertain, it will have a negative impact on QBE's operating earnings in 2020.

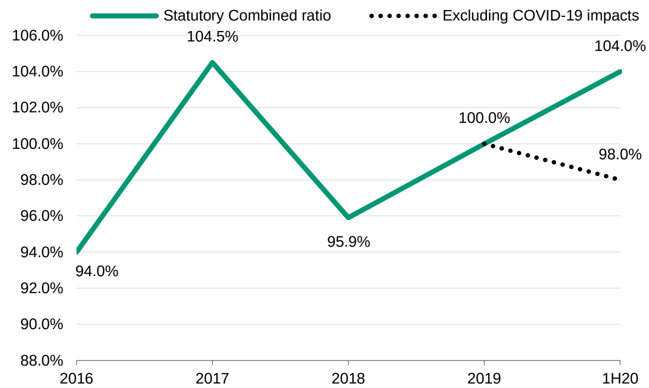
The group expects to report a 1H20 net statutory loss after tax of around $750 million, primarily reflecting the impacts of coronavirus pandemic as well as higher catastrophe experience losses, and negative prior accident year claims development. The group also expects to report a net investment loss of around $125 million as a result of extreme investment market volatility. Despite the negative earnings impacts, QBE's balance sheet position remains strong with high levels of capital, improving leverage metrics and high levels of liquidity, which mitigate its short-term earnings volatility.

The group expects the coronavirus pandemic will negatively impact 1H20 underwriting result by around $335 million. This includes approximately $150 million of net incurred claims, $115 million of additional risk margin related to the uncertainty of the coronavirus pandemic, $50 million of premium concessions and reinsurance reinstatement costs and $20 million of expenses including motor vehicle premium refunds. The pandemic has, or is expected to, adversely impact multiple lines of business including property (business interruption), reinsurance, workers' compensation, casualty, accident & health, trade credit, lenders' mortgage insurance and landlords' insurance. QBE has also cautioned that there could be other less significant impacts, both positive and negative, that are not readily identifiable or quantifiable. While reduced personal motor claims frequency has been a positive, the earnings benefit has been negated through refunds on premiums to customers.

In addition to the negative effects of the coronavirus pandemic, the group's 1H20 result will be negatively impacted by adverse catastrophe experience of around $60 million. Catastrophe claims in the half will be around $310 million, exceeding QBE's $250 million allowance, reflecting the significant catastrophe costs of the Australian bushfires and the Australian east coast hail and storm. Furthermore, earnings will be negatively impacted by adverse net prior accident year claims development of around $120 million, primarily reflecting strengthening in North America. Around half of the development pertains to closed North American portfolios while the remainder reflects a further impact from heightened social inflation and increasing industry-wide losses with respect to Hurricane Irma.

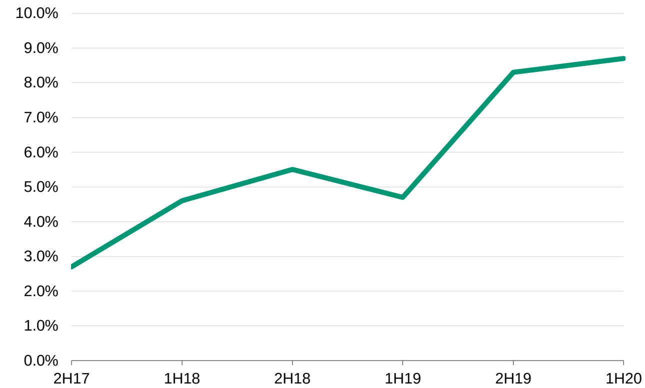
These increased costs are likely to lead to a 1H20 combined operating ratio for the group of around 104% (excluding the impact of changes in risk-free rates used to discount net outstanding claims), however, underlying performance is stronger with the combined ratio excluding the coronavirus impacts, would be around 98% (Exhibit 1). On a positive note, QBE continues to benefit from increasing premium prices. Renewal rate increases averaged about 8.7% during the half compared with 4.7% in 1H19 (Exhibit 2). Premium rate momentum accelerated during the half in the group's North America and International divisions. On a constant currency basis and adjusting for asset sales completed in 2019, gross written premium grew by around 10% during the half.

Exhibit 1
Underlying business performance remains sound
Combined ratio



Source: Company disclosures

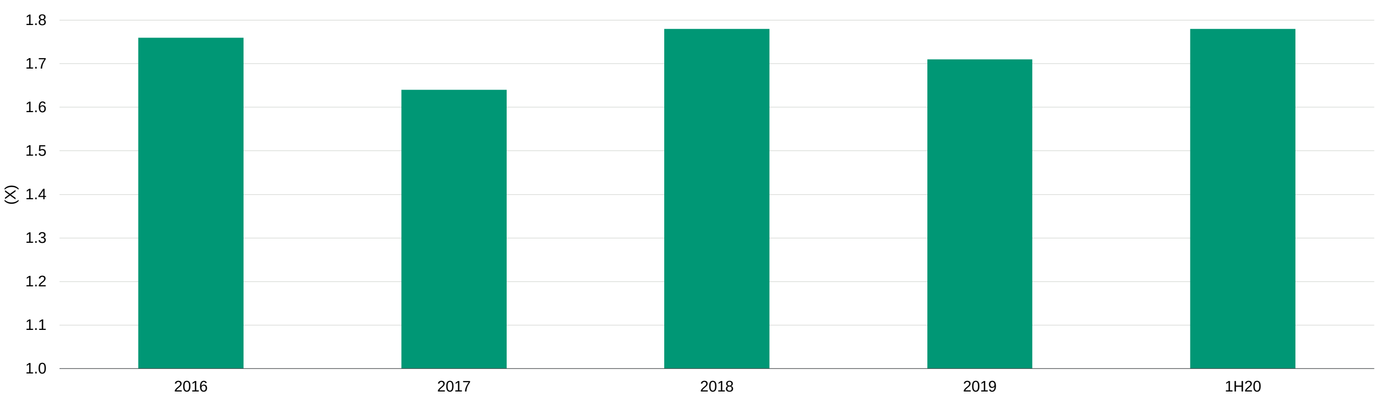
Exhibit 2
Premium rate increases will boost revenue
Premium renewal rate increases



1H20 estimate
Source: Company disclosures

Despite the significant earnings impact, the group's balance sheet strength remains very strong. QBE's capital position remains strong following the group's c.$842 million capital raising during the half. The group's regulatory capital position is expected to be around 1.78x, near the top end of its 1.6-1.8x target range (Exhibit 3). Group head office liquidity remains very high and is expected to be around $1.5 billion at 30 June 2020.

Exhibit 3
Capital position remains strong following equity raising
Regulatory solvency coverage ratio



1H20 estimate
Source: Company disclosures

Endnotes

1 The rating shown in this report is the company's senior unsecured debt rating and outlook.

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Proposal to reform Mexico's retirement system is credit positive for private pension fund asset managers

On 22 July, Mexico's (Baa1 negative) President Andres Manuel Lopez Obrador announced a proposal to reform the country's retirement system, which would strengthen the current defined contribution system, mainly by gradually increasing contributions by employers.

If approved by congress, the reform would be credit positive for private pension fund asset managers, or *administradoras de fondos para el retiro* (*afores*), because it affirms the continuity of the industry by removing the threat of the industry's nationalization, which some in congress had proposed. It would also be positive for Mexico's more than 67 million workers with an individual account in the system, whose potential pension benefits would improve. Changes in the law also imply that more workers will be eligible for a minimum guaranteed pension, expanding the base of eligible pensioners. Exhibit 1 details the key reforms.

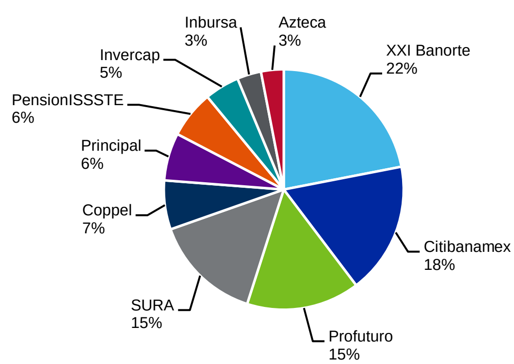
Exhibit 1
Key reforms of Mexico's retirement system

	Current Plan	Proposed Plan
Total Contributions (% of salary over eight years)	6.50%	15%
Employers Contribution (% of salary over eight years)	5.15%	13.875%
Weeks Worked Required	1250	750

Source: Moody's Investors Service, based on Ministry of Finance information

Among the afores, the proposal would be most positive for the 10 largest asset managers by market share (see Exhibit 2), boosting their growth prospects because of their recognized brands and substantial assets under management.

Exhibit 2
Mexico's largest afores will continue to dominate the market



Sources: Comision Nacional del Ahorro para el Retiro data and Moody's Investors Service.

The proposal is the result of close collaboration between representatives of the private sector, Mexico's Ministry of Finance, congress and workers' unions, which suggests improving relations with the private sector following several disagreements with the government.

Discussions about reforming the retirement system had intensified since a 2019 proposal by some in congress to nationalize the system, which threatened afores' continuity. It also raised concerns among some workers who did not want the government to manage their pension savings. Proposals to replace afores with a governmental agency or to return to a defined benefit system would have significantly disrupted the business of pension asset managers, pension insurers and related sectors.

Afores are the second-largest institutional investors in Mexico, after the banks, and are accumulating assets. They are likely to grow through at least 2030, and their funds under management 25% of GDP, up from about 16%, or MXN4.308 trillion ($187 billion), now.

Around 47% of the assets managed by afores are from returns on investment activities on behalf of more than 67 million workers' individual accounts.

Workers would benefit from the reform proposal through a substantial increase in the replacement rate because of a gradual increase in the contribution rate to 15% of an individual's salary from 6.5% now. The increase would be charged to employers incrementally over an eight-year period.

Around 76% of the working-age population is not eligible to receive a pension, based on the 1,250-week requirement of contributions to the system to receive at least the minimum guaranteed pension (when savings are not enough to buy a private pension). The reform proposes reducing the number of weeks of contributions to 750 to allow more workers to receive at least the minimum guaranteed pension.

The average minimum guaranteed pension will also increase to MXN4,345 from MXN3,289, a significant improvement which is expected to increase the average replacement rate to around 40% from 30% currently. The minimum guaranteed pension will be calculated according to the recipient's age, weeks of contribution and last base salary, with the aim of benefiting those on lower incomes.

It is unclear if the effect of the reform would be net positive or net negative on Mexico's fiscal accounts. The reform has the potential to lower future social pressures on the government to complement the defined contribution system, thereby reducing contingent liabilities, since the proposal will improve the current very low replacement rates. However, the reform expands the base of who is eligible to access a minimum guaranteed pension, which risks generating additional fiscal pressures on the government accounts.

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Virus surge and expiration of federal relief measures imperil US' economic recovery

Originally published on 23 July 2020

Evidence of a US (Aaa stable) economic recovery has built in recent weeks, underpinned by a relaxation of lockdowns and the roll-out of significant fiscal policy support. We expect the recovery to continue over the second half of this year and unemployment to continue to gradually decline. However, the rapid rise in COVID-19 infections in much of the country and the potential expiration of key support measures to households and small businesses may weaken the pace of the nascent recovery.

A number of cities have posted a record number of new daily cases in recent weeks, including Los Angeles, Dallas, Houston, Atlanta and Miami (see Exhibit 1), even as growth in new cases has decreased in New York, Chicago and Washington D.C. and several other big cities. Metro areas where newly confirmed cases are rising together account for 26.8% of US GDP.

Exhibit 1

COVID-19 infections are rising in some big cities, while steadily falling in others

City	Daily new cases per 100k people (monthly average)								GDP at risk (share of US total GDP)
	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Jan.21 - Jul.12	Metropolitan Statistical Area
High and rising									
Los Angeles	0.0	0.0	0.6	6.2	9.6	15.1	24.2		5.4%
Dallas	0.0	0.0	0.5	3.4	7.9	12.7	33.9		2.6%
Houston	0.0	0.0	0.3	3.9	4.0	12.1	22.2		2.4%
Atlanta	0.0	0.0	1.2	7.1	5.1	6.6	25.2		1.9%
Miami	0.0	0.0	1.4	12.7	7.1	17.8	74.4		1.6%
Phoenix	0.0	0.0	0.4	2.2	3.9	24.4	57.8		1.3%
Tampa	0.0	0.0	0.5	1.9	2.1	15.5	45.0		0.8%
Rising									
San Francisco	0.0	0.0	1.1	4.3	3.8	3.7	7.3		2.4%
Seattle	0.0	0.0	2.8	6.0	2.9	2.7	6.2		1.9%
San Diego	0.0	0.0	0.5	2.7	3.9	5.7	13.9		1.3%
San Jose	0.0	0.0	1.1	2.5	1.0	2.3	7.4		1.3%
Minneapolis	0.0	0.0	0.4	3.4	16.1	9.6	10.0		1.3%
Denver	0.0	0.0	1.6	10.6	12.3	6.8	8.1		1.0%
Portland	0.0	0.0	0.3	2.4	1.8	4.0	6.2		0.8%
Sacramento	0.0	0.0	0.3	1.9	0.6	3.0	11.8		0.8%
Improving									
New York City	0.0	0.0	11.9	53.6	15.9	5.3	3.7		8.4%
Chicago	0.0	0.0	1.8	18.9	27.2	9.0	7.6		3.3%
Washington, D.C.	0.0	0.0	1.5	17.0	21.0	8.1	5.5		2.5%
Boston	0.0	0.0	3.3	45.8	23.5	8.5	4.4		2.2%
Philadelphia	0.0	0.0	1.5	25.8	18.7	7.5	7.4		2.0%
Detroit	0.0	0.0	4.3	26.1	7.6	4.7	5.3		1.2%
Baltimore	0.0	0.0	0.6	10.1	18.2	11.9	11.5		1.0%

Sources: Moody's Investors Service, U.S. Bureau of Economic Analysis, the Economic Tracker, and How Did COVID-19 and Stabilization Policies Affect Spending and Employment? A New Real-Time Economic Tracker Based on Private Sector Data, by Raj Chetty, John Friedman, Nathaniel Hendren, Michael Stepner and the Opportunity Insights Team, June 2020

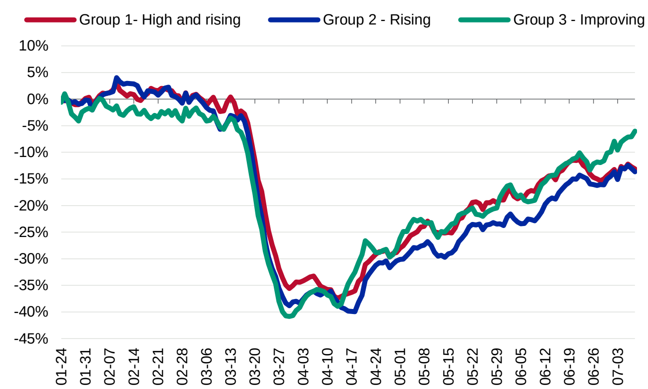
States in the West and the Sun Belt, which relaxed lockdown measures in May, have mostly driven the steady nationwide rise in new cases and hospitalization since mid-June. In response, a number of states including Arizona, Arkansas, Delaware, Idaho, Louisiana, Maine, Nevada, New Mexico, North Carolina and Washington are slowing their reopenings. Virus cases have also spiked in California, which is reimposing restrictions on bars, restaurant, gyms and other indoor activities. As of July 15, 35 states had reported a rise in new COVID-19 infections for two consecutive weeks. The three worst-affected states are Florida, Texas and California, which together make up more than 25% of US GDP.

The worsening situation is putting the ongoing consumption recovery at risk. Retail sales had a strong monthly pickup of 7.5% in June, putting sales at only 1% below the January peak. The June increase followed an 18.2% jump in May. However, the improving trend may not carry through July and the coming months, as important parts of the economy remain shut. High-frequency indicators show that household spending is falling in cities where new infections are rising and that visits to retail and recreation locations have dropped since the end of June (see Exhibits 2 and 3). Consumer sentiment has also darkened, as reflected in the drop in the University of Michigan consumer sentiment indicator to 73.2 in early July from 78.1 in June.

Exhibit 2

Spending trends compared with pre-pandemic levels in three city groups

Percentage difference from mid-January



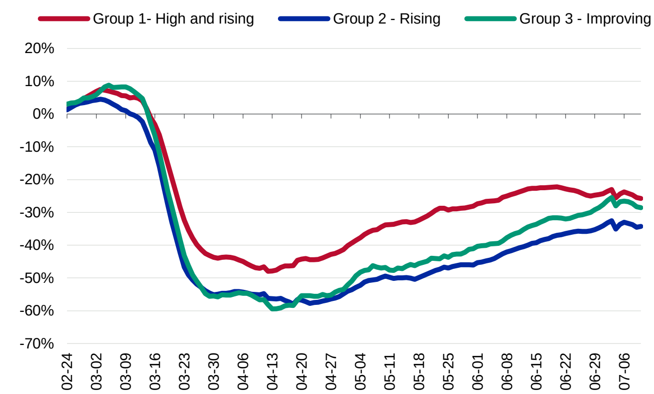
Seasonally adjusted credit/debit card spending relative to January 4-31 2020 in all merchant categories, seven-day moving average.

Sources: Moody's Investors Service, the Economic Tracker, and How Did COVID-19 and Stabilization Policies Affect Spending and Employment? A New Real-Time Economic Tracker Based on Private Sector Data, by Raj Chetty, John Friedman, Nathaniel Hendren, Michael Stepner and the Opportunity Insights Team, June 2020

Exhibit 3

Mobility trends compared with pre-pandemic levels in three city groups

Time spent at retail and recreation locations, percentage difference from February



GPS mobility data indexed to Jan 3-Feb 6 2020.

Sources: Moody's Investors Service and Google COVID-19 Community Mobility Reports

Even without stringent lockdowns, such as those imposed in April, fear of infection will likely cause consumers to voluntarily cut back on economic activities that require a high degree of person-to-person contact. Thus, spending on a wide variety of services will likely remain below normal for months. In particular, sectors such as hospitality, leisure and nonfood retail will remain under significant stress.

Slower reopenings or renewed closures will also likely slow the improvement in labor markets, if not reverse it. Workers who had expected to be furloughed or laid off temporarily could find themselves unemployed for longer. Despite payroll employment gains in May and June, around 16 million individuals continued to receive unemployment benefits in the week ended July 11. The insured unemployment rate based on the continued claims data remains high at 11.1%. Additionally, around 13 million independent contractors, self-employed and gig workers are receiving assistance under the Pandemic Unemployment Assistance program.

Economic outlook also at risk from potential termination of key support measures to households and small businesses

The economic recovery is also at risk from the prospect of reduced fiscal support to households and businesses experiencing income and revenue losses. A number of key federal relief measures are set to expire in the coming weeks. Although we expect Congress to pass another relief package, there is considerable uncertainty as to the size, scope and timing of that agreement.

A reduction in federal support from current levels, which is likely, would constitute a financial shock for many households and businesses given still-high levels of unemployment and depressed economic activity. Without additional federal support, we also expect state and local governments to continue to address sharp revenue losses through procyclical spending cuts, posing further risks to the economic and employment outlook. While Congress acted swiftly and forcefully during the initial phase of the outbreak, the prevailing policy uncertainty may hurt consumer and business sentiment.

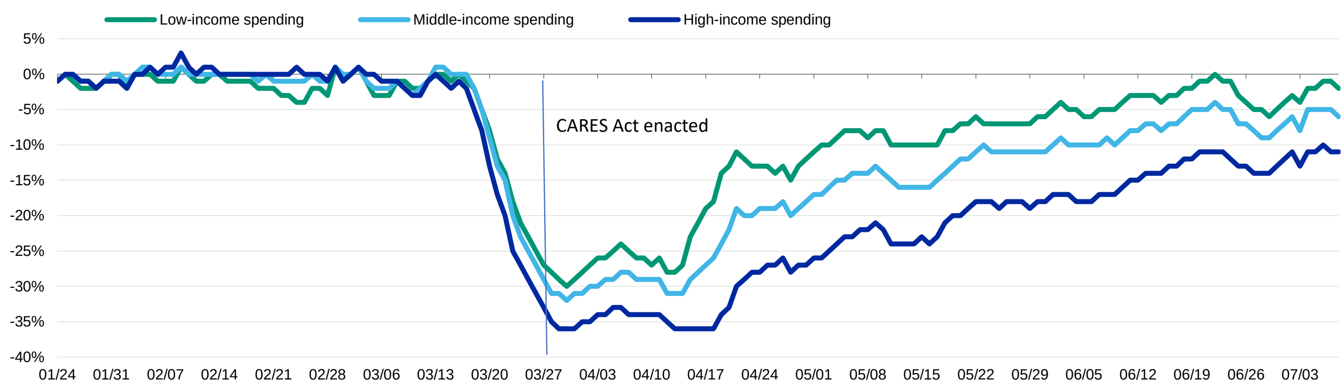
A pullback or reduction in federal aid would hurt a broad range of consumer-facing sectors. While federal relief measures and bank forbearance programs have so far supported consumer loan performance, performance will likely rapidly deteriorate if the government lifts these measures before a significant recovery in the labor market.

Most notably, the termination of the $600-a-week supplemental federal unemployment insurance (UI) benefits on July 31 would create an income cliff for unemployed workers. Consumption data suggest that the supplemental UI, along with other relief measures such as the one-time stimulus checks provided through the Coronavirus Aid, Relief and Economic Security (CARES) Act, have supported a recovery in household spending since mid-April. This is especially true for lower-income workers, who have been affected by layoffs disproportionally and have a greater propensity to consume than higher-income households (see Exhibit 4). In fact, it is unlikely that the strong consumption recovery in May and June would have occurred without the CARES Act relief measures.

Exhibit 4

Spending by low-income consumers is close to pre-pandemic levels

Change in consumer spending by income level



Seasonally adjusted credit/debit card spending by consumers living in ZIP codes with high, middle and low median income, relative to January 4-31 2020 in all merchant categories, seven-day moving average.

Source: Moody's Investors Service, the Economic Tracker, and How Did COVID-19 and Stabilization Policies Affect Spending and Employment? A New Real-Time Economic Tracker Based on Private Sector Data, by Raj Chetty, John Friedman, Nathaniel Hendren, Michael Stepner and the Opportunity Insights Team, June 2020

A pullback in federal income support could also make it more difficult for many lower-income households to remain current on their rent, mortgages and other debt obligations. According to the National Multifamily Housing Council's Rent Payment Tracker, 91.3% of renters have made full or partial rent payments for the month of July compared with 93.4% over the same period last year, in large part because of federal relief measures. Federal moratoriums on evictions and foreclosures are set to expire in July and August. Together with a reduction in federal relief to households, the lifting of these moratoriums could result in a wave of evictions in the fall.

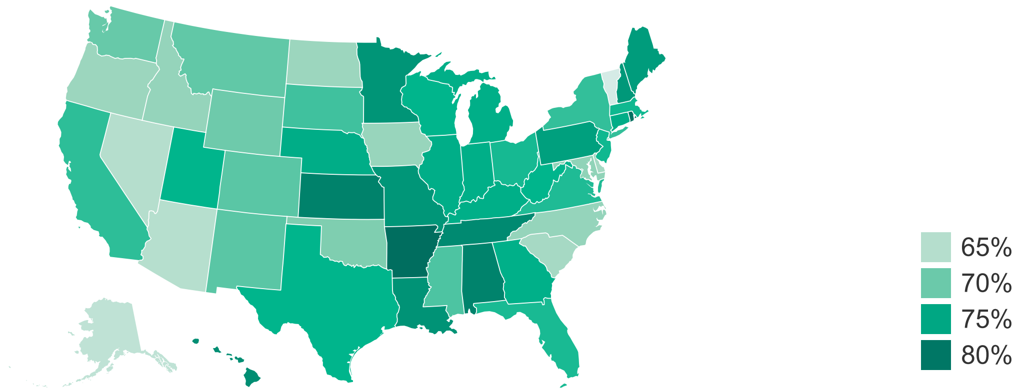
For small businesses, assistance provided through the Paycheck Protection Program (PPP) is likely to taper off over the coming weeks, which could precipitate further layoffs and permanent business closures. While the PPP has provided liquidity relief to many small businesses in need of assistance, it was designed to help businesses stay afloat and maintain staff during a short-lived economic disruption, not an extended downturn.[1]

Faced with a protracted period of revenue losses, many PPP loan recipients will struggle to maintain staff and keep their doors open. In a survey conducted by the National Federation of Independent Business in mid-June, before the surge in new infections, more than half of PPP recipients reported having exhausted their PPP loan proceeds and 22% anticipated having to lay off workers once the funds ran out. As of the end of June, roughly 70% of small businesses surveyed by the US Census Bureau had reported receiving assistance through the program, including in states where virus cases are rapidly increasing, such as in Texas and Florida (see Exhibit 5).

Exhibit 5

PPP distribution has varied by state but uptake has been high overall

Share of small businesses that have received a PPP loan



Sources: Moody's Investors Service and US Census Bureau Small Business Pulse Survey

The recently launched Main Street Lending Program, a Federal Reserve liquidity facility that aims to support credit to small and medium-size businesses, is unlikely to provide much relief to most small businesses that are currently under strain. With a minimum loan amount of $250,000, the program is geared toward a subset of midsize businesses that have not benefited from the Fed's corporate bond buying program and were likely too big to benefit from the PPP. Moreover, loans under these programs are not forgivable and recipients will incur higher indebtedness.

To date, significant fiscal and monetary support has prevented a widespread deterioration in the balance sheets of households and businesses, despite the magnitude of the shock. The longer it takes for the situation to normalize, the more fiscal support will be needed to prevent lasting damage to private-sector balance sheets. Inadequate measures would result in a much more protracted recovery in economic activity and employment than we forecast a month ago.

In addition, a more protracted health crisis could serve to more deeply entrench changes in consumer and business behavior that might have been only temporary had the outbreak been contained earlier. These include increases in remote work, more digital consumption of goods and services such as healthcare and leisure, and a decline in business travel, each of which would have significant credit implications for issuers in affected sectors.

Endnotes

1 **PPP loans are capped at 2.5 times average 2019 monthly payroll. Businesses initially had eight weeks to spend the loan proceeds. While the government has relaxed the eight-week spending requirement, it has not increased the maximum loan amount.**

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Ghana's widening fiscal deficit increases liquidity risks

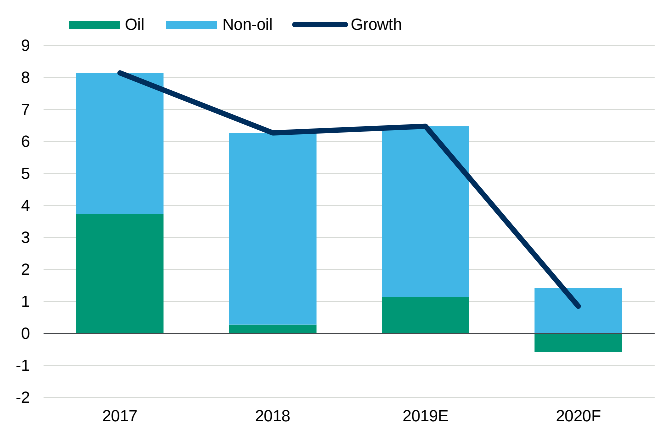
Originally published on 24 July 2020

On 23 July Ghana's (B3 negative) Minister of Finance Ken Ofori-Atta presented the mid-year review of the 2020 budget to parliament. The government now expects to record a deficit of 11.4% of GDP this year, compared to an initial budget target of 4.7% and the 7.8% figure announced in March. The widening of the country's fiscal deficit intensifies the government's liquidity risks given its already sizeable borrowing requirements and the constraints on its financing options in the current environment. We also expect its reliance on the central bank to finance these deficits will further weaken the country's external position. Moreover, pressures on spending are unlikely to ease as coronavirus cases continue to increase and with elections scheduled for 7 December.

The government revised both its revenue and spending estimates for the year. Revenue was written down 3.0 percentage points (pp) of GDP from the budget to account for the impact of lower oil prices and the steep decline in activity, while spending was revised up 3.8 pp to account for higher healthcare and interest expenditures. The government also announced the launch of a GH¢ 100 billion (26% of GDP) three and a half years stimulus package to support the economic recovery that would be mostly financed by a combination of the private sector and development finance institutions.

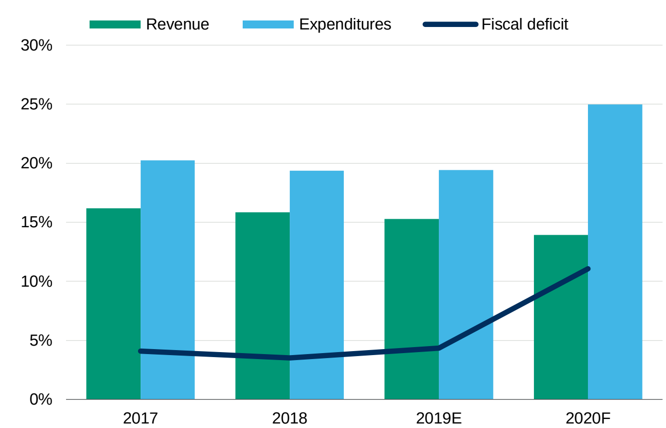
The upward revision in spending underscores the weakening in Ghana's already low debt affordability. Interest expenditures are set to rise to 6.8% of GDP, up from 5.4% of GDP in the budget, and would consume close to 50% of total revenue. The deficit estimate also excludes 2.1% of GDP in financial sector bailout costs that are below the line, as well as off-budget energy related costs that we estimate at around 1%-2% of GDP annually. (See Exhibits 1 and 2)

Exhibit 1
Growth decelerates significantly but remains positive
Percentage points of GDP growth



Source: National Authorities

Exhibit 2
The deficit is expected to widen significantly
% GDP



Source: National Authorities

The government intends to finance the gap between the revised deficit and the budget through a combination of central bank advances, exceptional financing and higher domestic debt issuance. Provisional budget execution up to end of fiscal 2020 (end-June) already shows net BoG advances to the government of GH¢ 13.2 billion (3.4% of GDP) following launch of a GH¢ 10.0 billion (2.6% of GDP) asset purchase programme in May.[1] Exceptional financing is broadly in line with what was announced in March and represents around 2.2% of GDP.[2] Finally, increased domestic debt issuance to the non-bank financial institutions by 1.9 pp of GDP accounts for most of the residual gap.

While neighbouring countries have announced similar asset purchase programmes, Ghana's ability to adjust its monetary policy is more constrained given its reliance on portfolio flows to meet both its fiscal and external financing needs. In its latest review of April, the IMF forecasts net portfolio inflows to amount to $1.2 billion during the year and to cover for close to 40% of the estimated current account deficit.

Gross foreign-exchange reserves remained robust at $9.2 billion at end-June, according to the government. This is up by $0.8 billion from year-end 2019 and covered the equivalent of 4.3 months of imports. However the increase largely reflects the $3 billion eurobond issuance in February[3] as well as $1.4 billion in exceptional financing. We forecast the current-account deficit will rise to around 4.5% of GDP this year, up from 2.8% in 2019, mainly driven by the drop in remittances that the government estimates to be $1.5 billion (2.3% of GDP) lower this year. In addition, the planned drawdown of part of the Petroleum Funds, which stood at $0.9 billion at end-March, will further weigh on the level of reserves.

The government's increased reliance on central bank financing for fiscal and quasi-fiscal activities risks undermining the efforts made by the authorities in building a sound macroeconomic framework during the previous IMF programme, which helped to usher in significant portfolio inflows. The latest reading of non-food inflation, a proxy for core inflation, stood at 9.2% in June, and was the highest recorded since the series began in August 2019. A prolonged increase of the monetary base to finance the government deficit as well as other quasi-fiscal activities would weaken the sustainability of the country's external position and impair the ability of the sovereign to finance its rising debt burden.

Endnotes

1 The coupon rate is pegged to the prevailing monetary policy rate with a 10-year tenor and two-year moratorium on both principal and interest payments

2 $1 billion from the IMF Rapid Credit Facility (RCF), $350 million from the World Bank's Development Policy Operation (DPO) and $82 million from the African Development Bank (AfDB)

3 $523 million was used to buyback the 2023 maturing eurobond

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Hertz's proposed agreement increases credit enhancement for senior rental car ABS holders

Originally published on 24 July 2020

On 24 July, The US Bankruptcy Court for the District of Delaware approved an interim resolution between The Hertz Corporation and its rental car asset-backed securities (ABS) holders by effecting an order under which Hertz will pay the noteholders $650 million in lease payments and dispose of more than one-third of its leased vehicle fleet by year-end at a required proceeds level of $3.9 billion.[1] The lease payments and vehicle sales proceeds will pay down roughly half of the aggregate balance of the senior rental car ABS, increasing credit enhancement and alleviating some performance uncertainty for the senior notes. Previously, Hertz had filed a motion in bankruptcy court to reject about one-fourth of its US fleet, or about 140,000 vehicles.[2]

Receiving some contractual payments will increase senior notes' credit enhancement. Under the order for temporary rent relief, Hertz is required to pay roughly one-third of its contractual lease payments to ABS holders in six equal installments from July to December, bolstering the credit enhancement supporting the senior rental car ABS and alleviating some performance uncertainty for the senior notes. The ultimate collateral backing the ABS is a fleet of vehicles under a single lease to Hertz. Under a master lease agreement, Hertz leases the fleet from a separate Hertz entity, structured as a bankruptcy-remote special purpose vehicle.

The combination of lease payments and required vehicle sales proceeds will increase credit enhancement to around 45% in December from 34% in June. Our December estimate assumes that Hertz makes the $650 million in lease payments and remits the $3.9 billion in vehicle sales' proceeds through year-end. The lease payments and sale proceeds will pay note interest and trust expenses, and then pay down roughly half of the balance of the senior notes.[3]

Hertz, which filed for Chapter 11 bankruptcy in May, has not made lease payments for the last three months. Hertz's first missed lease payment in April triggered an amortization event under the ABS trust and therefore the Class A notes will receive all lease payments and vehicle sales proceeds, net of bond interest and trust expenses, until the principal is paid in full. Following Hertz's lease payment default, the trust's letters of credit covered any shortfalls in interest on the notes.

Demand for car rentals declined severely as the coronavirus pandemic slashed travel plans, crippling Hertz's ability to make lease payments despite the fleet's operational importance. Hertz's full monthly lease payment obligations under the master lease ranged from $334 million to $638 million in the last 12 months.

Credit enhancement supporting the senior notes declined in April and May owing to Hertz's lapse in covering interest and depreciation on the vehicle fleet, despite vehicle sales proceeds being used to repay the notes. Vehicle prices were depressed in March and April. However, the strong recovery in the used vehicle market beginning in early May helped boost credit enhancement slightly in June, despite the missed lease payment.

On 29 May, we downgraded the ratings of 11 tranches of rental car ABS issued by Hertz Vehicle Financing II LP to Baa3 (sf). All 11 tranches remain on review for possible further downgrade.

Orderly vehicle dispositions will also help bolster senior notes' credit enhancement. Under the order, Hertz must dispose of 182,521 vehicles, or around 26,000 per month, producing cash flow that supports the senior notes.[4] The order sets a front-loaded schedule for a predetermined amount of vehicle disposition proceeds from June to December. Hertz's vehicle sales must yield the required proceeds each month. If the proceeds fall short, Hertz must make a payment to meet the requirement.

The $650 million in lease payments and required vehicle disposition proceeds of $3.9 billion, less note interest and trust expenses, equate to around 50% of the senior ABS outstanding as of 30 June. The senior ABS outstanding include the senior ABS we rate and the senior variable funding notes.

Gradual de-fleeting by Hertz and still-solvent rental car companies will likely result in only a low level of excess supply of used vehicles and a small weakening in sales prices, assuming that current used vehicle market conditions persist. For example, Hertz de-fleeting at a pace of 26,000 cars per month represents 6.5% of the U.S. wholesale auction used vehicle sales volume prior to the coronavirus pandemic of over 400,000 per month.

Used vehicle sales volumes and pricing began to improve in late April and increased considerably in May through mid-July, enabling rental car companies to de-fleet at prices similar to those prior to the pandemic. Continued pent-up demand, dealer inventory needs and fear of mass transit have bolstered the demand for used vehicles and their prices. However, demand will normalize as the pent-up demand and dealer inventory needs are satisfied. In addition, market conditions could turn if the coronavirus crisis deepens or economic conditions weaken.

According to the J.D. Power Used Market Update, around 419,000 used vehicles were sold in the wholesale auction market in the four weeks that ended July 12, close to the typical US sales volume prior to the pandemic. Used car prices have increased 30% over the past 12 weeks and are now 10% higher than at the beginning of March.

Endnotes

1 See Docket #805 at **Prime Clerk**. Hertz also agreed not to file any motions to reject its obligations under the master lease agreement until 15 January 2021. A partial or full rejection of the lease by Hertz would result in vehicle dispositions being subject to market prices.

2 In the unlikely scenario of the court allowing a partial rejection of the master lease, Hertz would not honor its contractual lease obligations related to those vehicles. Instead, Hertz would liquidate the vehicles and the sales proceeds would be used to repay the notes.

3 Our estimate also assumes the lease payments cover 2.0% of depreciation for the vehicles in the fleet and the current benchmark interest rate for the senior variable funding notes.

4 The disposition of 182,521 vehicles includes 42,721 vehicles that Hertz sold in June.

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Post-COVID shifts in consumption will affect credit fundamentals across sectors

Originally published on 23 July 2020

Summary

The sudden and broadly disruptive effects of coronavirus lockdowns and social distancing have led to a massive change in households' discretionary and non-discretionary consumption patterns in the US (Aaa stable). Some of these shifts will likely reverse once virus-related health fears ease and the economic recovery takes hold, while other changes will become more permanent either as health concerns linger or consumers favor the convenience, efficiency or cost effectiveness of new types of consumption. Three behavioral shifts will likely drive the long-lasting changes in consumption: accelerated digitalization, a greater share of time and consumption spent at home, and a transformation of travel, entertainment and leisure activity.

» **Lower-income households will undergo an extended period of lower capacity to consume.** Returning to pre-crisis employment levels will take several years, limiting the consumption capacity of lower-income households. Government transfer payments and forbearance measures will continue to help support these households, but a considerable drop-off in discretionary and non-discretionary consumer spending is likely once the support programs end.

» **Consumer adoption of digital products and services will continue to accelerate.** For companies, the increase in e-commerce and digital consumption during the pandemic amplifies the imperative to invest in technology and transform business models to stay competitive. At the same time, digitization raises cyber risks for both companies and their customers.

» **Demand for products supporting at-home work and leisure will rise.** Even once pandemic health concerns subside and more people return to physical offices and schools, demand for products that increase comfort, connectivity, efficiency and entertainment at home will increase. This trend will create opportunities for companies that supply these products.

» **Travel and out-of-home entertainment industry transformation will be ongoing.** The supply-and-demand dynamics of group activities are poised for change. Providing safe travel and entertainment outside the home may become more costly and the shifts in consumer behavior that occurred during the pandemic may be long-lasting.

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REPORT NUMBER 1239407