Credit Outlook

30 July 2020

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Black Knight's debt burden is at risk of rising more than 50% with planned Optimal Blue acquisition

Originally published on 28 July 2020

On 27 July, Black Knight Inc. (Ba2 stable) said that it had agreed with its partners Cannae Holdings Inc. and Thomas H. Lee Partners L.P. to purchase Optimal Blue, a provider of mortgage data, analytics and a marketplace for secondary trading of mortgage debt, for $1.8 billion. The planned acquisition, which Black Knight expects to complete by the end of September, is credit negative because it will likely result in a more than 50% increase to its debt burden.

Black Knight, Cannae and Thomas H. Lee Partners will form a joint venture to purchase and own Optimal Blue. The latter two parties will each pay $290 million cash and each receive a 20% share in the joint venture. Black Knight will contribute its Compass Analytics business line, valued at $100 million, plus about $1.0 billion of cash for a 60% joint venture interest. The Optimal Blue joint venture will be consolidated by Black Knight.

If Black Knight borrows the approximately $1,0 billion it needs to fund its share of the cash component of the acquisition, debt/EBITDA would expand from around 3.0x as of 31 March to almost 5.0x pro forma for the incremental debt and assuming no EBITDA contribution from Optimal Blue. However, we believe Optimal Blue will contribute some positive EBITDA in the 12 months after the acquisition closes.

We also note Black Knight's ownership interest in The Dun & Bradstreet Corporation (B2 stable) is worth over $1 billion, providing it with a noncore asset it could monetize to help provide cash for the acquisition or to repay a portion of any acquisition debt it incurs. As a result, we believe Black Knight could quickly bring financial leverage back below 4.0x in the 12 to 18 months following the acquisition's closing through the application of its free cash flow or by monetizing all or a portion of its Dun & Bradstreet stock. All financial metrics reflect Moody's standard adjustments. Black Knight's ratings, including the Ba2 corporate family and senior secured ratings, as well as the stable ratings outlook, are unchanged at this time.

Optimal Blue's historical revenue and profit have not been disclosed by Black Knight. Likewise, the company has not confirmed the source of the cash they need to close the transaction. If Black Knight were to incur debt that is not easily prepayable, thereby signaling it will maintain financial leverage above 4.0x beyond the next 12 to 18 months, the company's ratings and outlook could be pressured. Black Knight has an unused $750 million senior secured revolving credit facility it could access for cash to close the transaction and easily repay with free cash flow over time. We anticipate Black Knight will generate free cash flow of about $300 million a year, enabling debt repayment if it borrows to fund the purchase.

Edmond DeForest, *VP-Sr Credit Officer*
Moody's Investors Service
edmond.deforest@moodys.com
+1.212.553.3661

Karen Nickerson, *Associate Managing Director*
Moody's Investors Service
karen.nickerson@moodys.com
+1.212.553.4924

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AstraZeneca's deleveraging remains on track in new collaboration with Daiichi Sankyo

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On 27 July, AstraZeneca PLC (AZ, A3 stable) announced a collaboration agreement with Japanese pharmaceutical company Daiichi Sankyo Company, Limited (DS, A2 stable) for an antibody-drug conjugate in the oncology field. AstraZeneca will make $1 billion non-contingent upfront payments to DS, split roughly evenly between 2020, 2021 and 2022. Additional, milestone-based payments could reach up to $5 billion, of which $4 billion relate to sales-based milestones. The collaboration to develop a TROP2-targeting drug to treat cancers such as lung and breast could hold significant opportunity.

Although we expect that the new collaboration will not be accretive to earnings for several years, we forecast that AstraZeneca remains on track to achieve deleveraging to or below 3.0x Moody's-adjusted gross debt/EBITDA and positive Moody's-adjusted free cash flow by the end of 2021.

The $1 billion upfront cash consideration is relatively modest given the group's size, especially since it will be paid over three years. There are no other outflows before the acquired pipeline asset reaches the market, at which point milestone payments would be gradual and spread over many years. Despite the group's negative free cash flow, mainly because of its high dividend payments, we expect that AZ will continue to divest non-strategic assets, which will help fund the upfront payments along with cash on hand. The new collaboration risks modest earnings dilution from the additional R&D investment it will trigger, but we believe AstraZeneca retains flexibility managing its development spend so as to prioritise its most promising pipeline assets.

Given the drug's early development stage (currently in phase I/II), the asset's success remains highly uncertain and equally risky. However, the combination of a relatively new biotechnology (the antibody-drug conjugate), AZ's knowledge of it through its existing collaboration with DS on Enhertu, which uses the same mechanism, and large unmet medical need across several tumour types, it could provide a significant market opportunity. The drug in development targets the TROP2 protein which is highly expressed in multiple cancers such as lung and breast.

US biotech Immunomedics has a TROP2-targeting drug approved by the US Federal Drug Administration for breast cancer, but continued approval may be contingent on confirmation of clinical benefits in trials. The new asset's competition would also come from existing cancer treatments that use other mechanisms such as PD-1 inhibitors, including Merck & Co., Inc.'s (A1 stable) Keytruda, the world's largest-selling drug (approved in multiple cancers) and Bristol-Myers Squibb Company's (A2 negative) Opdivo, which can be combined with the new drug.

AZ's free cash flow was negative $2.1 billion for the 12 months to March 2020, including a $675 million upfront payment to DS for the 2019 collaboration on Enhertu, another antibody-drug conjugate, but underlying cash generation (i.e., before one-off payments) improved in 2019 and first-quarter 2020. Over these reporting periods, AZ also reduced its Moody's-adjusted leverage to around 4.3x as of 31 March 2020 from 5.3x in 2018 and we expect further deleveraging in the rest of 2020 and 2021 when it should reach 3.0x or below.

Frederic Duranson, ***AVP-Analyst***
Moody's Investors Service
frederic.duranson@moodys.com
+44.20.7772.1950

Richard Etheridge, ***Associate Managing Director***
Moody's Investors Service
richard.etheridge@moodys.com
+44.20.7772.1035

Reckitt Benckiser's strong first-half performance and improved outlook bode well for leverage

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On 28 July, Reckitt Benckiser Group Plc (RB, A3 negative) reported a 15.7% year-on-year increase in its company adjusted operating profit for the first half of 2020, driven by strong sales in both hygiene and health products, and stated that the outlook for the rest of the year has improved since its last update in April. The increase in profit and the better outlook are credit positive and the performance, if sustained in the second half, will result in improving debt metrics. We now anticipate that leverage, measured in terms of Moody's adjusted debt to EBITDA, will improve to around 3x in 2020, thus moving toward the threshold required to maintain the A3 rating.

We estimate that leverage, measured in terms of Moody's adjusted debt to EBITDA, stood at 3.2x as of 30 June 2020, unchanged from 2019, and slightly above the 3x threshold for the current rating. However, assuming a similarly strong performance in the second half of the year, we see scope for the ratio to improve toward 3x by the end of 2020. Management's more confident guidance bodes well for the for the rest of the year, although visibility remains clearly limited given the unpredictable evolution of the coronavirus pandemic in all markets. Management said that it expects revenue, margin and earnings performance for the full year to be better compared with its previous expectations in February and April, despite uncertainties of pantry unloading, particularly in Health over-the-counter products.

The pandemic increased demand for RB's products in the first half, particularly for Dettol, Lysol, Mucinex, Nurofen and vitamins, minerals and supplements. It also increased e-commerce revenue, which was up over 60%, more than compensating for lower offline sales. In the first half, e-commerce sales accounted for around 12% of total revenue.

Overall, RB reported total like-for-like revenue growth of 11.9% to £6,911 million, of which volume accounted for 11% and price/mix 1%, resulting in improved operating margins. Hygiene revenue rose 16.1%, supported by strong growth for Lysol and Finish in most markets, and Health revenue increased 9.3%. Management estimates underlying revenue growth - i.e., excluding the tailwind from the impact of coronavirus - was between 3% and 4%. This was despite some deferral of certain shipments, which we understand was due to some disruption in the activity of traditional retailers, in the distribution channels and in the supply chain connected to China.

Operating profit was up 13.4% on a reported basis at £1,595 million (2019 £1,406 million), resulting in operating margins of 23.1% on a reported basis and 24.5% on a company adjusted basis (2019: 23.6%). Coronavirus-related costs were £69 million, including investments in temporary social distancing infrastructure for the safety of our people, co-packing costs to increase short term capacity, and additional freight and warehousing costs. Management expects these costs will be sustained in the foreseeable future.

Roberto Pozzi, ***Senior Vice President***
Moody's Investors Service
roberto.pozzi@moodys.com
+44.20.7772.1030

Richard Etheridge, ***Associate Managing Director***
Moody's Investors Service
richard.etheridge@moodys.com
+44.20.7772.1035

Amazon Fresh rolls out free deliveries in the UK, a credit negative for UK grocers

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On 28 July, Amazon.com Inc. (A2 positive) said it has rolled out free grocery deliveries for its Prime members in London through its Amazon Fresh service and intends to expand the service to the whole of the UK by the end of the year.

Amazon's initiative is credit negative for UK grocers because it will attract some of their customers, reducing their sales volumes, revenue and profit. It may also prompt them to respond in kind, with similarly negative effects on their key performance indicators and, ultimately, debt metrics.

Amazon's share of the UK grocery market is currently negligible – the company does not feature amongst the ten largest grocers - but has reportedly signed up 15 million customers to its Fresh business. Amazon may be seeing the sharp increase of grocery online sales due to the COVID-19 pandemic as an opportunity to expand its fresh food operations in the country. Indeed, online sales have nearly doubled in the UK since the beginning of the lockdown, currently representing around 13% of total grocery sales.

Amazon has struggled to make inroads into fresh groceries – not only in the UK. It fully owns Whole Foods Market, whose UK arm Fresh & Wild we estimate has revenue of only a few hundred million of British pounds. In order to expand its grocery delivery capabilities, it signed a wholesale supply agreement with Wm Morrison Supermarkets Plc, the UK's fourth largest grocer by market share, under which the company provides Amazon Fresh with a wide range of Morrisons ambient, fresh and frozen products, as well as third-party products.

Operating margins from online deliveries are already thin for UK grocers and below those earned by brick and mortar sales, and Amazon's initiative risks making these operations even less profitable for them. Although none of the largest UK grocers, including Tesco Plc (Baa3 stable) and J Sainsbury plc, disclose their online revenues and profits, all of them of recently guided towards flat profits year on year despite a sharp increase in revenues as they benefit from the closure of restaurants and food chains, increased food consumption at home, market share gains from the discounters as these lack online delivery capabilities, as well as business rates relief worth several hundred millions of pounds.

The shift of sales to the grocers' less profitable online operations is one of the main reasons, beside rising costs related to the measures taken to make sure the stores remain safe, for the flat profit guidance given by the major UK grocers despite overall favourable market conditions.

Roberto Pozzi, ***Senior Vice President***
Moody's Investors Service
roberto.pozzi@moodys.com
+44.20.7772.1030

Charles O'Shea, ***VP-Sr Credit Officer***
Moody's Investors Service
charles.o'shea@moodys.com
+1.212.553.3722

Richard Etheridge, ***Associate Managing Director***
Moody's Investors Service
richard.etheridge@moodys.com
+44.20.7772.1035

NEXT Group's second-quarter results are credit positive, but full recovery for company and sector are uncertain

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On 29 July NEXT Group plc (Baa2 stable) published details of its sales performance in the 13 weeks to 25 July, the second quarter of fiscal 2021, which ends January 2021. These results are stronger than our expectations, a credit positive.

NEXT's sales in the second quarter were 28% lower than recorded in the corresponding period in fiscal 2020. The reduction reflects the effect of the UK-wide closure of nonessential retail stores between 23 March and 15 June. This is nevertheless well ahead of the 56% year-on-year decline for the quarter included in the company's central planning scenario detailed in its 29 April trading statement.

The results include an encouraging 9% year-on-year increase in online full price sales, fuelled in part by the store closures. This partially offset the complete absence of in-store sales until reopenings began and the still material 32% like-for-like in-store sales shortfall since then. We note that online despatches in the second quarter were 17% lower than a year earlier, but that higher online sales benefited from a mix shift towards childrenswear and homeware which contributed to much lower online returns compared to last year, at 23% compared to 42%. We expect the lower return rate will also have been margin accretive.

The company has updated its scenario analysis for fiscal 2021 revenue and profits, with its central scenario now that second half sales will be down 19% and its full-year sales will be down 26% versus fiscal 2020. On this basis, the company forecasts full-year profit before tax (pre IFRS 16) of £195 million. Its previous central scenario of minus 35% full-year sales the company guided to break-even profit before tax.

The stronger-than-expected results and the company's more positive outlook for the full year are credit positive. NEXT's ratings and stable outlook were already supported by its conservative financial policies, consistently strong execution, and its sizeable and profitable online business. We therefore continue to believe that NEXT will be able to return to precrisis revenues, profitability and credit metrics within 12-18 months. However, at this stage various downside risks continue to weigh on the outlook for the apparel sector, including employment levels, consumer confidence, and the possibility of a second wave of the pandemic and another widespread lockdown.

David Beadle, ***VP-Sr Credit Officer***
Moody's Investors Service
david.beadle@moodys.com
+44.20.7772.5390

Danh Nguyen-Thanh, ***Associate Analyst***
Moody's Investors Service
danh.nguyen-thanh@moodys.com
+44.20.7772.5585

Richard Etheridge, ***Associate Managing Director***
Moody's Investors Service
richard.etheridge@moodys.com
+44.20.7772.1035

B&M's much stronger outlook for first-half EBITDA will reduce leverage, a credit positive

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On 28 July, European grocery and general merchandise value retailer B&M European Value Retail S.A. (Ba3 stable) said that it anticipates company-adjusted EBITDA of £250-£270 million in the first half of fiscal 2021 (ending 28 March 2021), 73% higher than in first-half fiscal 2020. If sustained, the stronger-than-expected EBITDA, will lower B&M's leverage toward 3.5x from 4.0x as of fiscal 2020 ended 28 March 2020.

We expect B&M's Moody's-adjusted net debt/EBITDA ratio will improve in fiscal 2021 (compared to our previous expectation of a slight deterioration), and likely fall well below the 3.75x-4.5x range we expect for the company's Ba3 rating. Any rating action would depend on the sustainability of the improvement, the use of higher free cash flows and, ultimately, on the financial policy of the company, which we do not expect to change, although the company announced that a new chief financial officer will take over in the second half of the year.

Management had already flagged that revenue was up 27% year on year in first quarter, but was previously uncertain about the sustainability of the performance in the second quarter. As a result of the strong revenue growth and higher but relatively limited additional operating fixed costs (warehousing and transport), B&M said it now expects its first-half fiscal 2021 EBITDA to be around £100-£120 million higher than £151 million in first-half fiscal 2020 on a comparablebasis, excluding the German operations (Jawoll) sold last year.

The much stronger guidance for first-half EBITDA, which is not comparable, reflects factors including the contribution of new stores opened in the period, good performance at the French operations (Babou) after reopening the stores and for UK frozen food activities (Heron), as well as the temporary business rates relief.

Management refrained from providing guidance for the rest of the fiscal year given the significant uncertainty about the pandemic and the macroeconomic outlook.

Roberto Pozzi, *Senior Vice President*
Moody's Investors Service
roberto.pozzi@moodys.com
+44.20.7772.1030

Richard Etheridge, *Associate Managing Director*
Moody's Investors Service
richard.etheridge@moodys.com
+44.20.7772.1035

Globalworth's green bond issuance reduces refinancing risk while enhancing liquidity

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On 22 July, Globalworth Real Estate Investments Limited (Baa3 negative) announced the issuance of a €400 million senior unsecured bond under its new green bond framework, the proceeds of which it will use to refinance €226.9 million of its €550 million of debt due in June 2022. We would also expect the company to use some of the remaining proceeds to partially repay its €200 million revolving credit facility, which it fully drew down in March 2020 as a liquidity backstop amid the coronavirus pandemic.

The refinancing measure is credit positive because it will significantly reduce the concentration of maturities in June 2022 from 33% of outstanding debt to 20%. Additionally, the refinancing will extend Globalworth's debt maturity profile. The company's liquidity will remain strong with around €565 million cash on hand as of June 30 2020.

On a pro forma basis reflecting the bond issuance, net debt will be broadly unchanged and within our quantitive rating guidance. Considering remaining utilisation under the revolving credit facility purely as liquidity backstop, we expect the company's Moody's-adjusted ratio of debt to total assets to be around 44% versus 38.4% at year-end 2019, while net debt/EBITDA will be unchanged at 8.6x.

Following all refinancing measures during the first half of 2020 average cost of debt slightly decreased to 2.73% from 2.83% as of the end of July 2020. We expect the fixed charge coverage to remain solid at around 3x for the full year 2020.

Globalworth completed the issuance under a new green bond framework within the company's €1.5 billion European medium-term note program. The issuance demonstrates the company's ability to tap nontraditional pockets of liquidity that link the bond issuance with environmental, social and governance (ESG) related uses, and benefit from a broader investor base. Furthermore it supports the company's growing track record in accessing public debt markets, even in a more uncertain economic environment.

Ana Luz Silva, CFA, *AVP-Analyst*
Moody's Investors Service
ana.silva@moodys.com
+49.69.70730.914

Moritz Mayer, *Associate Analyst*
Moody's Investors Service
moritz.mayer@moodys.com
+49.69.70730.951

CNPC and Sinopec's pipeline assets spinoff will lower their net debt, reduce capital needs and increase liquidity

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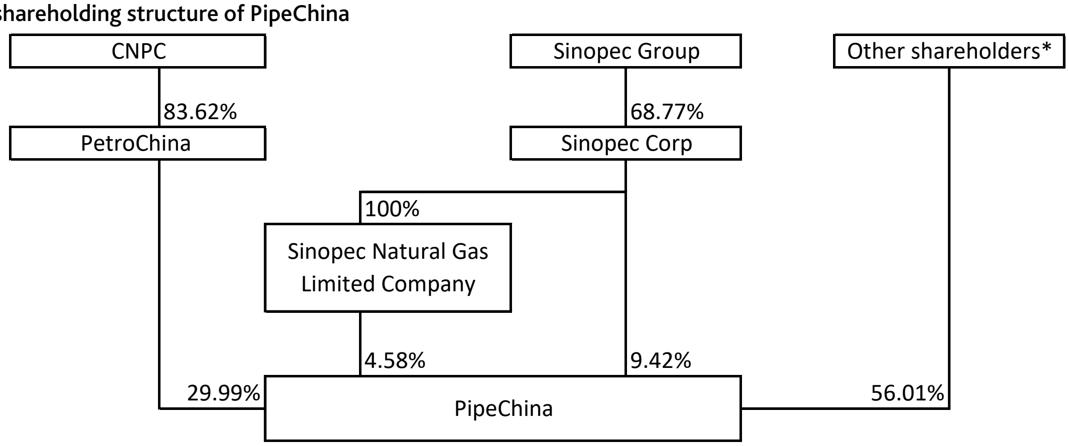
On 23 July, PetroChina Company Limited (PetroChina) and China Petroleum and Chemical Corporation (Sinopec Corp, A1 stable), which are key listed subsidiaries of China National Petroleum Corporation (CNPC, A1 stable) and China Petrochemical Corporation (Sinopec Group, A1 stable), respectively, announced that they – and their subsidiaries – agreed to sell major oil and gas pipelines, certain oil and gas storage facilities, and liquefied natural gas (LNG) terminals and ancillary facilities to China Oil and Gas Pipeline Network Corporation (PipeChina).

The transactions are credit positive for CNPC and Sinopec Group because the large cash consideration will lower their net debt, supplement capital spending needs and improve liquidity, although the spinoff will reduce business diversification and revenue. We do not expect the transactions to lower the strategic importance of CNPC and Sinopec Group to the Government of China (A1 stable).

CNPC (including PetroChina and its subsidiaries) will receive a 29.9% stake in PipeChina (see exhibit) and around RMB119 billion in cash for the sale of its assets, which are valued around RMB268.7 billion in total. Sinopec Group (including Sinopec Corp and its subsidiaries) will take a 14% stake in PipeChina and receive RMB52.6 billion in cash for its sold assets, which are valued around RMB122.7 billion. The debt associated with CNPC and Sinopec Group's pipeline-related assets will be transferred to PipeChina.

Illustrative shareholding structure of PipeChina



*Other shareholders include China Chengtong Holdings Group Ltd. (12.87%); China Reform Holdings Corporation Ltd. (12.87%); China Insurance Investment Co., Ltd. (9.00%); China Central SASAC (4.46%); CNOOC Gas and Power Group (2.90%); CIC International Co., Ltd. (2.00%); Silk Road Fund Co., Ltd. (2.00%).
Sources: Transaction announcements from PetroChina and Sinopec Corp

The cash considerations are equivalent to around 28.5% of CNPC's cash balance at the end of 2019 and 34.8% of Sinopec Group's, which will signicantly reduce their net debt positions. If the transactions had been completed at the end of 2019, CNPC's net debt would have been around RMB262 billion, 34% lower than the actual level of RMB398 billion. Similarly, Sinopec Group's net debt would have been 21% lower than its actual level of RMB361 billion at the end of 2019.

We estimate that because of the bigger reduction in net debt, pro forma net debt/EBITDA for CNPC will decline to 0.7x compared with 0.9x at the end of 2019 while Sinopec Group's net debt/EBITDA will decline to 1.3x compared with 1.6x at the end of 2019.

The transactions will lower CNPC and Sinopec Group's capital spending on pipeline, storage and LNG-related assets, greatly reducing their borrowing needs to fund investments. Instead, CNPC and Sinopec Group can use the cash considerations to support their capital spending and investments, particularly in the upstream natural gas development and downstream distribution and retail areas.

The transaction will also provide a relatively stable dividend stream for CNPC and Sinopec Group because PipeChina's midstream pipeline, storage and LNG terminal businesses have relatively low volatility. As stated in the companies' announcements, PipeChina will distribute around 30% of its net profit attributable to shareholders as dividends.

In addition, the strategic importance of CNPC and Sinopec Group to the Chinese government without the direct operation of the pipelines, storage and LNG terminal businesses will not significantly weaken. The two companies will remain dominant in upstream exploration and production, refining and chemical, and retail and marketing, businesses that are critical to China's energy security.

However, the transaction will reduce CNPC and Sinopec Group's business diversity and revenue, but the effect on their credit metrics will be manageable. The revenue from the asset sales account for 2% of CNPC's 2019 revenue and 13% of its EBITDA. The effect on Sinopec Group is even smaller, accounting for around 0.5% of its 2019 revenue and 4% of its EBITDA.

PipeChina was set up by the Chinese government at then end of 2019 to promote reform in the oil and gas sector. The government expects this independent new company to increase the operational efficiency of, and open up access to, the national pipelines and, therefore, attract investment from the private sector. Increased investment that expands China's natural gas pipeline network, combined with China's clean energy initiatives, boost the country's natural gas consumption potentially, which will in turn benefit CNPC and Sinopec Group because they are major suppliers of natural gas in China.

Chenyi Lu, CFA, CPA, *VP-Sr Credit Officer*
Moody's Investors Service
chenyi.lu@moodys.com
+852.3758.1353

Kai Hu, *Senior Vice President*
Moody's Investors Service
kai.hu@moodys.com
+86.21.2057.4012

Evelyn Liang, *Associate Analyst*
Moody's Investors Service
evelyn.liang@moodys.com
+86.21.2057.4026

Li Ma, *MD-Corporate Finance*
Moody's Investors Service
li.ma@moodys.com
+86.21.2057.4015

Bradesco, Itau and Santander Brazil's sustainable-development plan for Amazon is credit positive

On 22 June, in a meeting with Brazil's (Ba2 stable) Vice President Hamilton Mourão, Banco Bradesco S.A. (Ba2/(P)Ba2 stable, ba2[1]), Itau Unibanco S.A. (Ba2/(P)Ba2 stable, ba2) and Banco Santander (Brasil) S.A. (Santander Brazil, Ba1/(P)Ba1 stable, ba2) presented their plan to foster sustainable economic and social development in the Amazon region. The so-called Amazon plan outlines the banks' commitment to focus on environmental conservation and bioeconomic development; investment in sustainable infrastructure; and guaranteeing the regional population's basic rights.

The Amazon Plan would be credit positive for the three banks. We expect it will attract investors and strengthen the banks' revenue and loan origination in line with environmental, social and governance (ESG) principles and practices, reducing their exposure to ESG risks. Additionally, growth potential for credit operations is significant in the north region, which comprised only 3.3% of Bradesco's total loans and 2.2% of Itau Unibanco's as of 31 March.

By offering differentiated credit lines or instruments to finance expanded sustainable supply chains, as in the production of cocoa, chestnut and açaí, the banks will strengthen local businesses and originate loans that adhere to ESG standards. The additional inflow of resources into the region will also expand a market for the banks' green assets and financial instruments, contributing to the generation of fee revenue.

The plan proposes basic infrastructure investments that have positive social effects, such as housing, sanitation, energy, internet access, environmentally friendly river transportation and technologies that foster the bioeconomy.

To address ESG risks that may stem from the implementation of the Amazon Plan, the three banks will create a committee formed by members with different expertise in social and environmental issues in the region. This committee will also develop metrics and objectives designed to address local challenges. During 2020, the three banks will work on detailing the ten initiatives that comprise the plan.

The three banks, which are part of the Dow Jones Sustainability Index (DJSI), unveiled the Amazon Plan after more than 50 CEOs (including theirs) of large Brazilian and foreign companies on 6 July published a letter citing their concerns about Brazil's environmental problems.

International agreements to promote investments that take account of ESG considerations have made sustainable finance a key theme globally in recent years, giving banks a key role in financing the projects required to establish a sustainable economy. At the same time, the banks' ESG risks are more significant because of changes in regulations, government policy, social attitudes and market developments. Banks with weak ESG credentials risk losing customers and social considerations such as financial inclusion can affect banks' profitability.

Endnotes

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

Alexandre Albuquerque, *VP-Senior Analyst*
Moody's Investors Service
alexandre.albuquerque@moodys.com
+55.11.3043.7356

ECB extends dividend ban despite banks' resistance to COVID-19 effects

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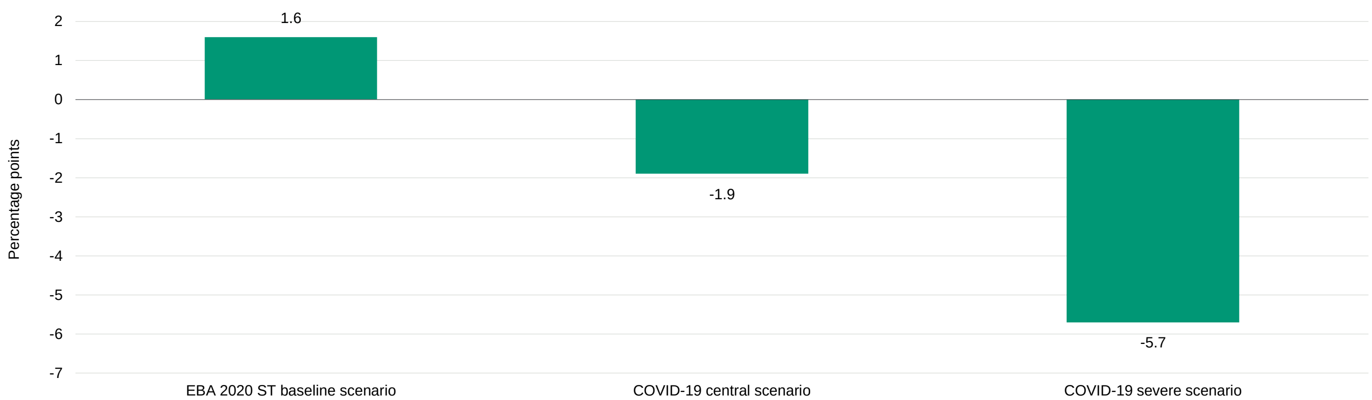
On 28 July, the European Central Bank (ECB) published the results of a vulnerability analysis to assess the effect of two coronavirus-related scenarios (central and severe) on 86 large banks over a three-year period that ends in 2022. Although this credit-positive assessment shows that overall the largest euro area banks can absorb the effects of the COVID-19 crisis, the ECB said it will extend its ban on dividend payments and share buybacks until January 2021.

Under the central scenario – which the ECB expects – the aggregate Common Equity Tier 1 (CET1) capital ratio of the 86 banks directly supervised by the Single Supervisory Mechanism would decline by 1.9 percentage points to 12.6% in 2022 from 14.5% as of year-end 2019. Under a more severe scenario, the depletion would be 5.7 percentage points (3x the base-case effect) reducing the CET1 ratio to 8.8% by the of end 2022. The exhibit below shows the effect on the 86 banks' aggregate CET1 capital ratios under the various scenarios.

CET1 capital ratio depletion over 2019-22 for the European Central Bank's various scenarios and the European Banking Authority's 2020 stress test



Source: European Central Bank

According to the ECB, the methodology and the central and severe scenarios largely incorporate the effect of coronavirus-related monetary, supervisory and fiscal relief measures. However, the framework did not attempt to model the effect on banks' CET1 ratios from risk-weighted asset (RWA) migration. Collateral or other forms of credit mitigation were incorporated at the bank level to the extent that banks disclosed this information at year-end 2019. The vulnerability analysis covered the same risks as in the European Banking Authority's (EBA) stress testing, whose results served as a reference point, and assumed a static balance sheet.

The ECB did not provide individual bank results, making it difficult to discern which banks were near, or fell below, their minimum regulatory requirements under the two scenarios, and which still exceeded their minimum requirements. However, the ECB provided a breakdown of outcomes by quartiles. For example, the 25% percentile indicates a CET1 of 6.8% under the severe scenario.

Despite the results, the ECB extended the ban on the payment of dividends and share buybacks, asserting that it lacks sufficient visibility to lift the ban on dividends and buybacks. The ban continues to apply to banks that maintain rather high CET1 ratios, including under the severe scenario (a 12.9% ratio is indicated for the 75% percentile), presumably above their Supervisory Review and Evaluation Process requirement. In so doing, it looks as if the ECB sought to avoid stigmatizing banks unable to pay dividends because of a weak capital position. However, the ECB also said that banks would be allowed to pay catch-up dividends when dividend payments resume.

The dividend decision, which is similar to one made by the UK, was expected because it follows a European Systemic Risk Board's 27 May recommendation that European authorities request financial institutions under their supervisory remit to refrain from dividend distributions and share buybacks at least until 1 January 2021. The ECB will reconsider its position on dividends in the fourth quarter this year, but has already said that banks could resume dividends in 2021, even if it prompts a breach of their Pillar 2 guidance, subject to a case-by-case assessment.

How the ECB's two scenarios affected the 86 banks varied based on banks' business models and mix. Global and universal banks were able to partially offset the effect of credit losses with higher-than-average operating income (both interest and noninterest), while small domestic and retail lenders were more negatively affected. Within risk types, credit risk contributed 2.8 percentage points of CET1 capital deterioration in the central scenario and 5.5 percentage points of deterioration in the severe scenario, driven by unsecured consumer and corporate exposures.

The ECB will not discuss the outcome of its vulnerability assessment with the banks it assessed, but will rely on the outcome of the assessment exercise to challenge banks' medium-term capital planning in the context of the supervisory review and evaluation process and the severity of their macroeconomic assumptions. The ECB continues to urge banks to keep lending to help stabilize the economy and reaffirmed its commitment to allowing banks to tap their capital (Pillar 2 guidance and combined buffers) and liquidity buffers. In addition, the central bank will not require the replenishment of banks' capital buffers before the end of 2022.

Alain Laurin, *Associate Managing Director*
Moody's Investors Service
alain.laurin@moodys.com
+33.1.5330.1059

Laurie Mayers, *Associate Managing Director*
Moody's Investors Service
laurie.mayers@moodys.com
+44.20.7772.5582

Frederic Drevon, *MD-Global Banking*
Moody's Investors Service
frederic.drevon@moodys.com
+44.20.7772.5356

Regulator confirms UK bank distribution suspensions until at least January 2021, a credit positive

Originally published on 29 July 2020

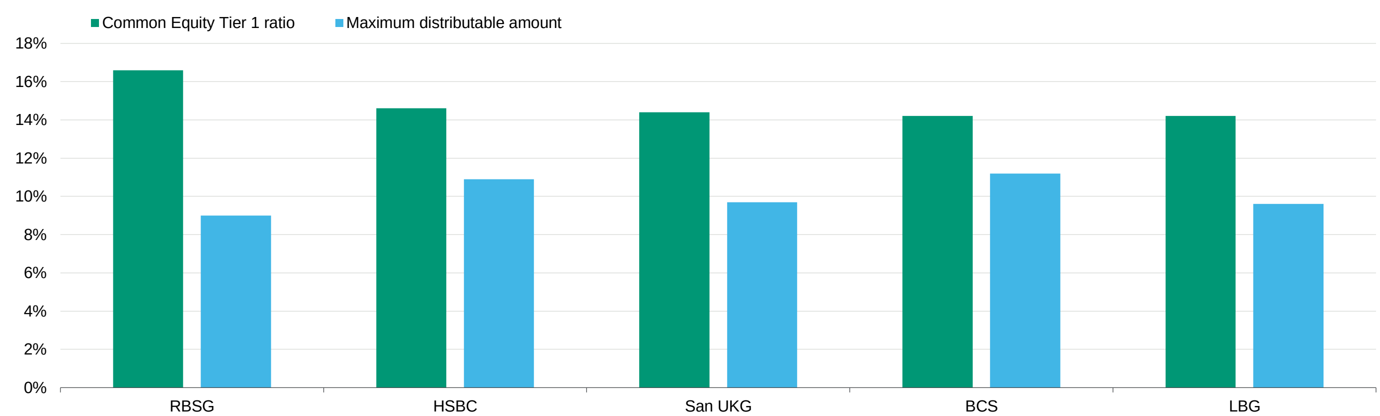
On 28 July, the UK Prudential Regulation Authority (PRA) said it would review in the fourth quarter UK banks' planned dividend payments and share buybacks for payment after 2020. The plan follows the PRA's request in March that UK banks suspend their dividend payments, share buybacks, and senior staff cash bonuses until the end of 2020. The possibility of continued restrictions beyond 2020, market and economic conditions warranting, is credit positive for the UK banking sector.

The PRA intends to incorporate the banks' current and projected capital, market conditions, the economic environment and uncertainty about future outcomes in its fourth-quarter assessment of banks' planned dividend payments. The PRA provided firm guidance in March that capital distributions be suspended until the end of 2020, compared to the ECB's original October 2020 guidance.

Greater capital retention provides protection for bondholders, while also helping to maintain the cushion between banks' regulatory maximum distributable amount (MDA)[1] and their Common Equity Tier 1 (CET1) ratios.

The exhibit below shows the five largest UK banks each have at least 300 basis points between their current CET1 ratio and MDA requirement. We expect UK banks CET1 ratios and buffers to decline over the coming quarters. The pandemic-induced deterioration in the economy and migration of risk weighted assets as the creditworthiness of the banks' customer bases erodes will result in a negative impact on revenues. The decline in pre-provision income from lower demand for credit may be partially offset for banks with material capital markets operations, because of increased customer activity on the back of increased market volatility particularly in the first and second quarters.

Large UK banks' Common Equity Tier 1 capital ratio and maximum distributable amount
Data as at 31 March 2020; Barclays as of 30 June 2020



BCS = Barclays plc; RBSG = The Royal Bank of Scotland Group; HSBC = HSBC Holdings plc; San UKG = Santander UK Group Holdings plc; and LBG = Lloyds Banking Group
Source: The banks

Endnotes

1 This is the regulatory requirement which banks capital must exceed to continue to make capital distributions to shareholders as well as to pay coupons on Additional Tier 1 instruments (AT1). Regulators will incrementally prevent capital distributions, unless they have not already done so, if a bank's capital falls below this amount.

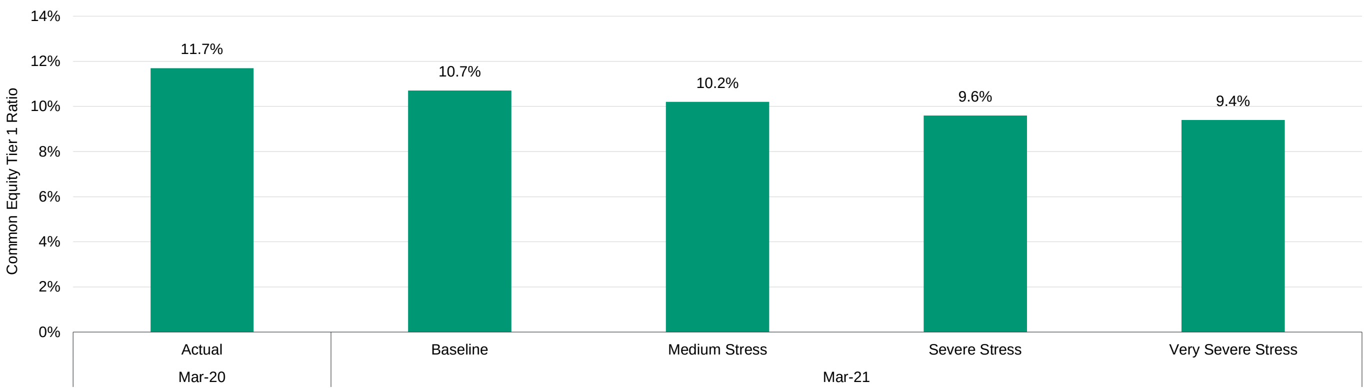
Maxwell Price, *Associate Analyst*
Moody's Investors Service
maxwell.price@moodys.com
+44.20.7772.1778

Laurie Mayers, *Associate Managing Director*
Moody's Investors Service
laurie.mayers@moodys.com
+44.20.7772.5582

Reserve Bank of India stress test results indicate high risk to asset quality from the deep economic shock

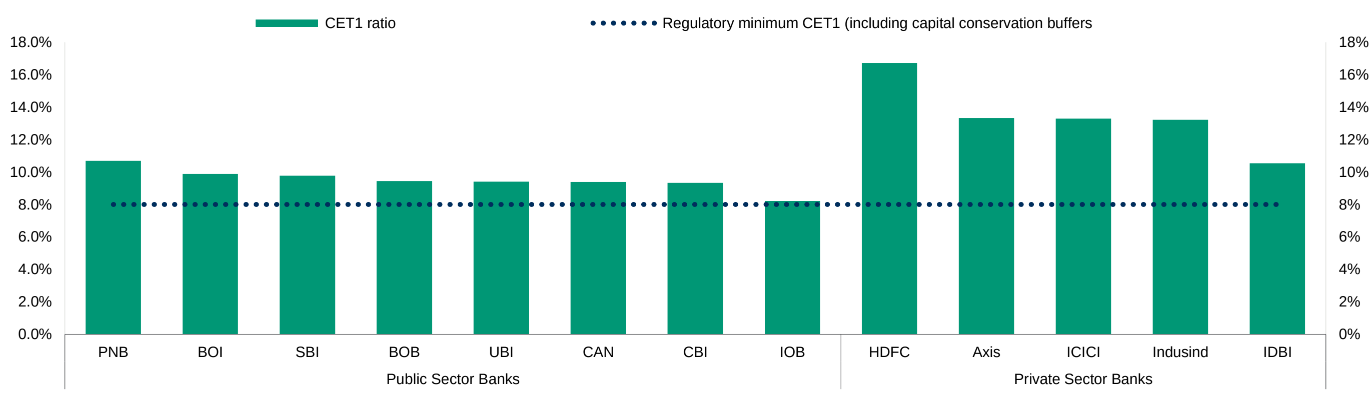
On 24 July, the Reserve Bank of India (RBI) published its Financial Stability Report and results of banking system stress tests. The results show that banks' gross nonperforming assets will rise meaningfully under all four stress test scenarios, with banks' Common Equity Tier 1 (CET1) ratio declining by one to two percentage points (Exhibit 1). However, most banks' capital ratios would remain above the regulatory minimum, a credit positive that reflects the banks' balance sheets' resilience to the stress of the coronavirus-induced economic downturn, as well as government infusions of capital to rated public-sector over the past two years (Exhibit 2). Therefore, even with the estimated decline, capitalization at these banks will be higher than at the trough in 2018.

Exhibit 1
Indian banks' Common Equity Tier 1 ratio in stress test scenarios



Source: Reserve Bank of India July 2020 financial Stability Report Issue No.21

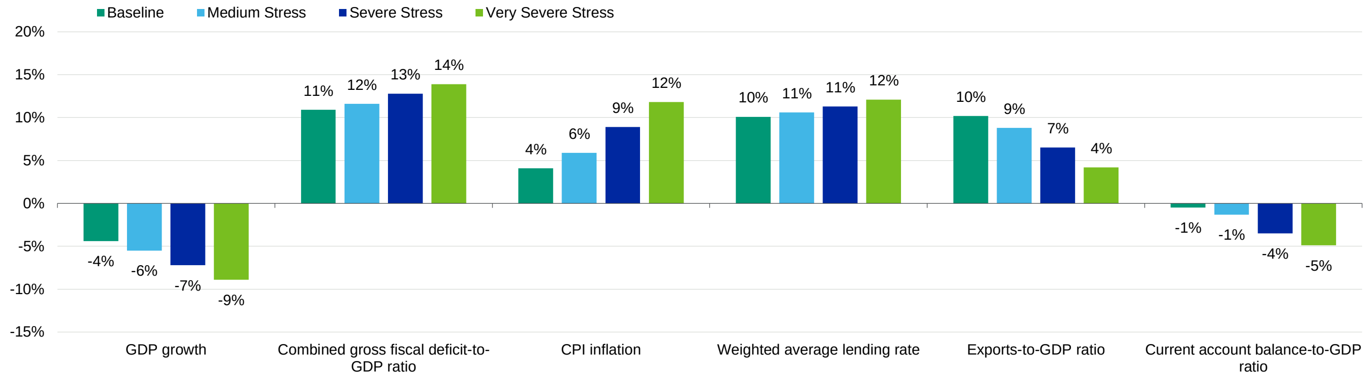
Exhibit 2
Moodys-rated banks Common Equity Tier 1 ratios



Key: PNB = Punjab National Bank, BOI = Bank of India, SBI = State Bank of India, BOB = Bank of Baroda, UBI = Union Bank of India, CAN = Canara Bank, CBI = Central Bank of India, IOB = India Overseas Bank, HDFC = HDFC Bank, ICICI = ICICI Bank, Axis = Axis Bank, IndusInd = IndusInd Bank, IDBI = IDBI Bank.
CET1 ratio for HDFC, ICICI, and Axis are as of the end of June 2020. All other banks listed are as of the end of March 2020.
Sources: Banks and Moody's Investors Service

The stress test scenarios ranged from base case to very severe, corresponding to GDP of negative 4.4% to negative 8.9% (Exhibit 3). The assumption of a sharp contraction in GDP growth reflects India's nationwide lockdown in response to the coronavirus pandemic, and uneven pickup in economic activity after the lockdown lifts. India's lockdown began in mid-March and remains in effect.

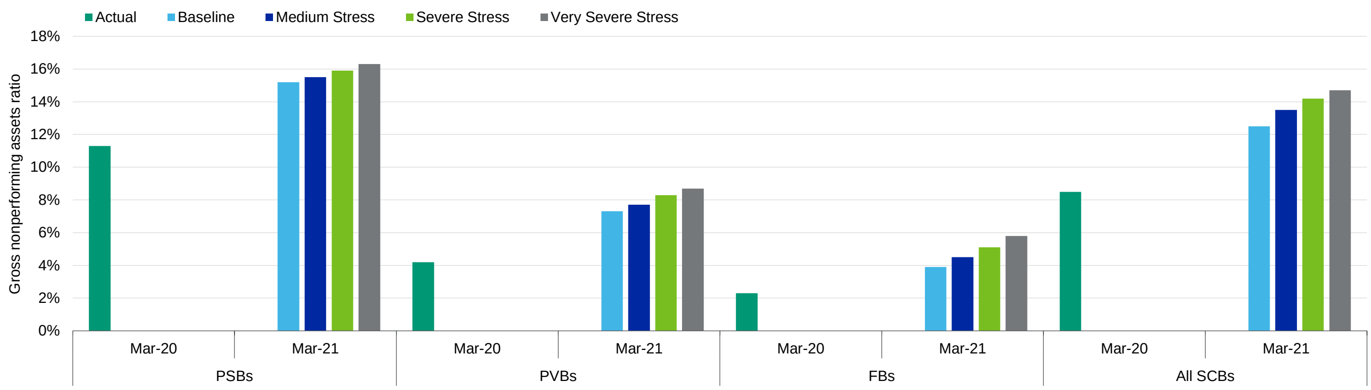
Exhibit 3
RBI macroeconomic scenario assumptions for 2020-21



Source: Reserve Bank of India July 2020 financial Stability Report Issue No.21

For all banks, the gross nonperforming assets ratio is modeled to increase by between four and six percentage points by March 2021, depending on the scenario (Exhibit 4). The significant increase is in line with our expectations on asset quality deterioration.

Exhibit 4
Projection of gross nonperforming assets ratios



PSBs = Public sector banks, PVBs = Private sector banks, FBs = Foreign banks, SCBs = Scheduled commercial banks
Source: Reserve Bank of India July 2020 financial Stability Report Issue No.21

The capital estimates also do not factor in new capital raising. Private-sector banks such as ICICI Bank Limited (Baa3 negative, ba1)[1] and Axis Bank Limited (Baa3 negative, ba1) have indicated an intention to raise capital. While no announcements have been made by the Government of India (Baa3 negative) for planned capital infusions in the fiscal 2021, which ends 31 March 2021, there is a history of capital infusion from the government to public sector banks when required.

Endnotes

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

Srikanth Vadlamani, *VP-Sr Credit Officer*
Moody's Investors Service
srikanth.vadlamani@moodys.com
+65.6398.8336

Randall Ho, *Associate Analyst*
Moody's Investors Service
randall.ho@moodys.com
+65.6311.2603

Graeme Knowd, *MD-Banking*
Moody's Investors Service
graeme.knowd@moodys.com
+65.6311.2629

Widespread take-up of loan moratorium risks asset quality stress at Indian banks, a credit negative

On 24 July, the Reserve Bank of India (RBI) published its Financial Stability Report with systemwide loan moratorium data, which showed that borrowers across multiple segments and all bank types took advantage of debt payment moratoriums. The large stock of loans under a moratorium indicates that banks' asset quality will decline because of a high risk of the deferred loans becoming bad loans when the moratorium ends. This situation is credit negative for banks because they would likely need to absorb credit losses if they have to restructure a large proportion of their loan books as a result of bad loans.

As part of measures to shield borrowers from the impact of the nationwide lockdown that started at the end of March 2020 because of the coronavirus pandemic, the RBI allowed banks to offer a moratorium on loan repayments for three months. It subsequently extended the moratorium period to 1 September 2020. During the moratorium, a loan can maintain its pre-moratorium classification even if the borrower makes no repayments.

The high take-up rates of the moratorium, as shown in the exhibit, are a leading indicator of potential asset quality stress, because not all borrowers will be able to restart payments

Loan moratorium take-up as of 30 April 2020

	Corporate		MSME		Individual		Others		Total	
	% of total customers	% of total outstanding	% of total customers	% of total outstanding	% of total customers	% of total outstanding	% of total customers	% of total outstanding	% of total customers	% of total outstanding
PSBs	28.8	58	73.9	81.5	80.3	80	48.8	63.7	66.6	67.9
PVBs	21.6	19.6	20.9	42.5	41.8	33.6	39.1	40.9	49.2	31.1
FBs	32.6	7.7	73.3	50.4	8.4	21.1	75.8	4.8	21.4	11.5
SFBs	78.8	43.7	90.5	52.3	90.9	73.2	64.6	12.3	84.7	62.6
UCBs	63.4	69.3	66.5	65.5	56.8	62	35.6	59.2	56.5	64.5
NBFCs	39.7	56.2	60.7	61.1	32.5	45.9	37.3	41.4	29	49
SCBs	24.7	39.1	43.1	65.3	52.1	56.2	45.7	55.7	55.1	50
System	30.8	41.9	45.8	65	50.4	55.3	45.7	54.6	48.6	50.1

PSBs = Public-sector banks, PVBs = Private-sector banks, FBs = Foreign banks, SFBs = Small finance banks, UCBs = Urban Co-operative banks, NBFCs = Non-bank financial companies, SCBs = Scheduled commercial banks, MSME = Micro, Small & Medium Enterprises
Source: RBI July 2020 Financial Stability Report Issue No.21

The high take-up rate by large corporates is surprising because companies typically have access to resources to weather near-term stress. Corporates' high take-up rates may have partly been motivated by a desire to preserve cash in uncertain economic times.

The high take-up rates by borrowers of small finance banks (SFBs) and non-bank finance companies (NBFCs) is a result of these institutions' greater exposure to riskier customer segments, such as those with more volatile income streams.

In the banking sector, the take-up rates by borrowers from public-sector banks has been much higher than those of borrowers from private-sector banks. The divergence is partly because of differences in the way public and private-sector banks have implemented the moratorium. Public-sector banks have largely operated an opt-out scheme, where customers are presumed to have taken up the moratorium unless they decide to opt out. In contrast, private-sector banks have largely implemented an opt-in scheme.

The higher take-up rates by corporate borrowers from public-sector banks also point to risks of the moratorium having an impact on borrowers' behaviour and, potentially, their willingness to repay. Banks have recognized this risk, which is why have they have begun to place much greater emphasis on collections even though they continue to offer repayment moratoriums. This stance is reflected in the decline in loans under moratorium at the end of June compared with the previous months.

Although the moratorium take-up rates are declining, they remain high. Furthermore, the decline in moratorium take-up rates does not necessarily mean that customers no longer in the moratorium category have no overdue payments. This is because most banks stop classifying a customer as being in the moratorium category even if only a partial repayment has been made.

Srikanth Vadlamani, *VP-Sr Credit Officer*
Moody's Investors Service
srikanth.vadlamani@moodys.com
+65.6398.8336

Randall Ho, *Associate Analyst*
Moody's Investors Service
randall.ho@moodys.com
+65.6311.2603

Graeme Knowd, *MD-Banking*
Moody's Investors Service
graeme.knowd@moodys.com
+65.6311.2629

BrightSphere Investment Group's sale of Barrow Hanley and planned deleveraging are credit positive

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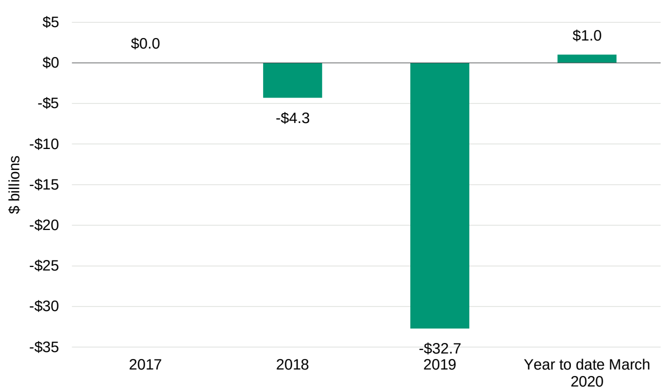
On 26 July, BrightSphere Investment Group Inc. (BSIG, Baa2 stable) announced that it plans to sell its US active-value equity affiliate Barrow, Hanley, Mewhinney & Strauss, LLC (Barrow Hanley) to Perpetual Ltd., a publicly traded financial services firm in Australia, for $319 million in cash. The sale price equals an 8x EBITDA earnings multiple, which we believe is a good value for an active equity asset manager with a history of net outflows. The parties expect the transaction to close in fourth-quarter 2020, subject to customary closing conditions and regulatory approvals.

The planned divestiture is credit positive for BSIG because Barrow Hanley has been experiencing net asset outflows for a number of years and BSIG plans to use a portion of the after-tax proceeds from the sale to pay down the $130 million balance on its credit facility. The debt paydown will more than offset the loss of Barrow Hanley's EBITDA and, as a result, we expect its debt/EBITDA ratio to fall to about 2.0x from a high of 2.5x at 31 March 2020.

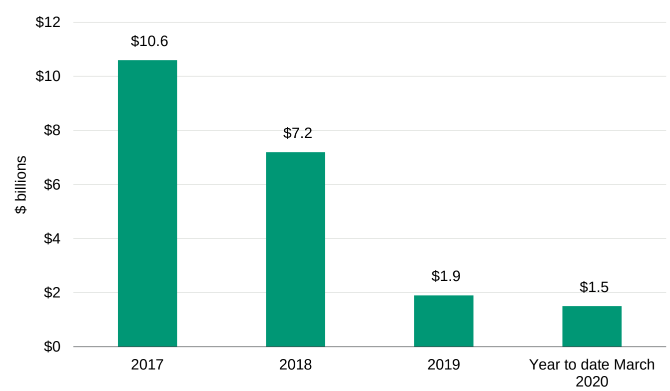
Pro forma for the Barrow Hanley sale, we expect that BSIG's net asset flows will improve to a more consistent positive position on an annual basis from a consistent negative position in recent years (see Exhibits 1 and 2). Consistent positive net asset flow generation is an important indicator of an asset manager’s ability to attract sustained demand for its investment products and services.

Exhibit 1
BrightSphere's historical net flows are negative



Excludes realizations that occur in the Landmark Partners business and excludes Heitman assets.
Sources: BSIG and Moody's Investors Service

Exhibit 2
BrightSphere historical net flows are positive excluding Barrow Hanley and Copper Rock



Excludes realizations that occur in the Landmark Partners business and excludes Heitman assets.
Sources: BSIG and Moody's Investors Service

The divesture of Barrow Hanley will allow management to focus attention and seed capital on BSIG’s growing Alternatives business segment, led by Landmark Partners, and Quant & Solutions business segment, led by Acadian Asset Management, resulting in consistent earnings growth in the future. Landmark Partners specializes in secondary market transactions of private equity, real estate and infrastructure investments, while Acadian is a leading quantitative investment manager of active global, international equity, and alternative strategies. These affiliates operate in sectors of the asset management industry that have higher-than-average asset growth rates.

Balancing these strengths, EBITDA will be concentrated among a smaller number of businesses. Post-transaction, BSIG expects its Alternatives and Quant & Solutions segments to generate 88% of EBITDA, up from 73% pre-transaction. Although not likely, this risks the company becoming vulnerable if market demand for alternatives declines, performance lags or business interruption occurs because of external or cyclical factors.

Separately, BSIG on 26 July also announced that it plans to sell its ownership interest in its small cap active equity affiliate Copper Rock Capital Partners, LLC to Spouting Rock Asset Management LLC and Copper Rock management. BSIG expects after-tax proceeds from the sale of approximately $15 million. Revenue and earnings from Copper Rock are minimal compared to Barrow Hanley given Copper Rock's small size.

Stefan Kahandaliyanage, CFA, *AVP-Analyst*
Moody's Investors Service
stefan.kahandaliyanage@moodys.com
+1.212.553.0317

Robert M. Callagy, *Associate Managing Director*
Moody's Investors Service
robert.callagy@moodys.com
+1.212.553.4374

Chile's pension reform will shrink funds' replacement rates and liquidity, and negatively affect the sovereign

Originally published on 29 July 2020

On 24 July, Chile's (A1 stable) President Sebastian Piñera enacted a reform to permit workers to withdraw up to 10% of their retirement accounts. The measure is credit negative for pension managers because the withdrawals will negatively affect private pension managers' (*administradora de fondos de pensiones* or AFP) liquidity and their operations. The reform also would be credit negative for the sovereign if it sets an institutional precedent and ultimately changes the way that Chile designs and approves fiscal polices.

The reform's approval deviated from Chile's common practice because congress proposed the reform, not the executive, which is contrary to Chile's established norms for laws that have a fiscal effect. Additionally, the approval was done without the technical analysis that usually complements these type of reforms. And, importantly, the reform is outside the framework set in the National Accord to which the government agreed with the opposition in congress on 14 June. That agreement established a limit for up to $12 billion in additional government spending in 24 months to address the coronavirus pandemic, a limit that will now be exceeded by this reform.

Allowing pensioners to withdraw up to 10% of their pensions will have an overall negative effect on government fiscal accounts of around $6 billion (2.5% of GDP) in the short and long term, according to Ministry of Finance estimates. That is because it implies less tax collection in the future given the withdrawls, an increase in the solidarity pillar,[1] a portion of which is funded by the government, and an immediate additional expense since current retirees can also withdraw their 10% portion. Positively, we expect that the potential withdrawal of around $20 billion, a Pensions regulator's (Superintendencia de Pensiones) estimate, will have a temporarily positive effect on the economy by boosting disposable income and consumption, mitigating the risk of a deeper economic contraction this year amid the coronavirus pandemic.

The reform aims mitigate the pandemic's negative economic effects on middle-class workers. This exceptional and voluntary onetime withdrawal of up to 10% of retirement accounts is limited to a maximum of CLP4.3 million (150 Chilean units of measurement [UF, Unidad de Fomento]) and a minimum of CLP1 million (35 UF). If the total is below 35 UF, the pension savings can be withdrawn in their entirety.

Workers withdrawing their funds will reduce expected future replacement rates, and the withdrawals would equal, on average, 44% of workers' (affiliated to the system) saving accounts. For 27% of those affiliated with the pension system, the withdrawals would amount to their total savings. The measure also will pressure AFPs' liquidity, since pension funds are target-date investment instruments with long-term horizons. It will lead to early redemptions of invested assets that as of June 2020 totaled $201 billion (CLP164.1 trillion) and around 82% of GDP. We note, the active role of the Superintendencia de Pensiones and the Central Bank to support the AFPs through this process.

The distribution of cash from withdrawals for around 11 million workers affiliated with the pension system will increase AFPs' exposure to operational risks that could damage their reputation and their clients' confidence. That is because we expect that AFPs will be administratively and technologically challenged to meet the demand for account withdrawals and will have to contend with digital fraud risk amid a preference for digital services during the pandemic.

We expect that AFPs' revenues will not be directly affected by the measure because fees charged are a percentage of workers' taxable income. Fees are more sensitive to unemployment rates, which as of May 2020 was 11.2%, four percentage points above the 7.2% for the same period 2019, and the highest since 2010. Four of seven AFPs manage approximately 90% of the system's assets under management: Administradora de Fondos de pensiones Habitat S.A. (28.1%), Administradora de Fondos de Pensiones ProVida S.A (24.6%), Sura Asset Management S.A.'s (Baa1 stable) subsidiary Administradora de Fondos de Pensiones Capital S.A. (19.3%) and Administradora de Fondos de Pensiones Cuprum S.A. (17.8%). Although we expect the proposal to be credit negative for all AFPs, smaller pension asset managers such as Administradora de Fondos de Pensiones Uno S.A., Administradora de Fondos de Pensiones Planvital S.A. and Administradora de Fondos de Pensiones Modelo S.A. will be more exposed.

Endnotes

1 The solidarity pillar complements the individual pension and sets a floor to the minimum pension a person can receive. It is funded by contributions from the government, the employer and the employee.

Ariane Ortiz-Bollin, *VP-Senior Analyst*
Moody's Investors Service
ariane.ortiz-bollin@moodys.com
+1.212.553.4872

Francisco Uriostegui, *Analyst*
Moody's Investors Service
francisco.uriostegui@moodys.com
+52.55.1253.5728

Robert M. Callagy, *Associate Managing Director*
Moody's Investors Service
robert.callagy@moodys.com
+1.212.553.4374

Croatian government's support will mitigate March earthquake's negative credit effects on capital city of Zagreb

Originally published on 29 July 2020

On 24 July, the Government of Croatia (Ba2 positive) adopted a draft law to reconstruct the capital city of Zagreb (Ba2 positive) and the surrounding area following a March earthquake that caused billions in damage, and sent the measure to Croatia's Parliament for approval. The law will expedite the city's recovery and limit the earthquake's overall negative credit effects, alleviating the negative pressure on Zagreb's finances and reducing its borrowing needs.

In accordance with the draft law, the central government will fund 60% of the total recovery costs while Zagreb and homeowners will each cover 20%. According to preliminary estimates presented in the Ministry of Construction and Physical Planning assessment, the earthquake damage in Zagreb and its surrounding area will total about €5.6 billion, or about 10.5% of Croatia's GDP.

The reconstruction will involve a complete renovation of hospitals, schools, cultural monuments and other public buildings up to the level of current earthquake resistance standards, and the government estimates that the renovation costs will total €11.5 billion. The government will establish a reconstruction fund to oversee the works, raise money for the reconstruction and serve as a one-stop shop citizens affected by the earthquake. The government estimates that the recovery efforts will take more than 10 years.

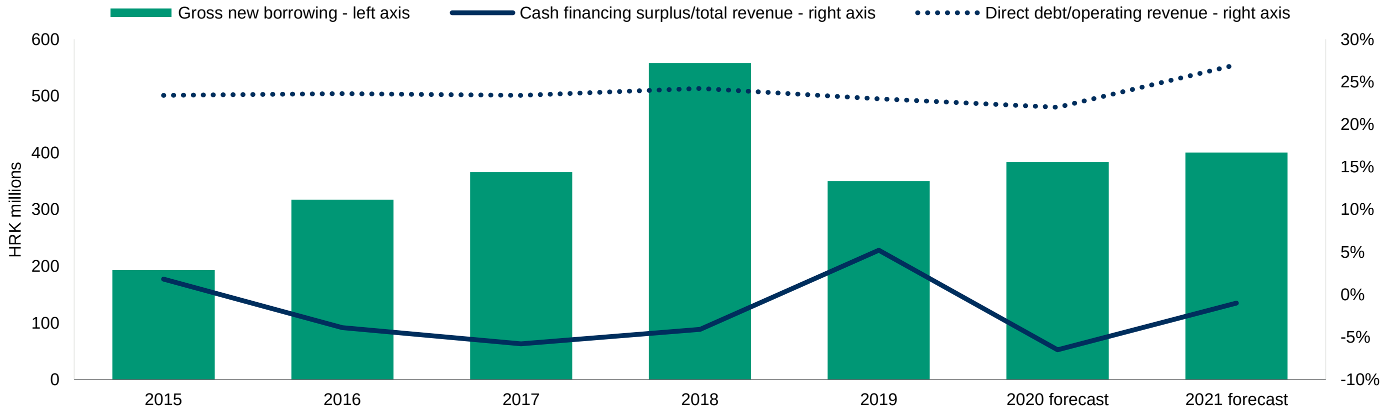
Although the mass evacuations and infrastructure damage caused by the earthquake are comparable to some of the region's worst recent natural disasters, the central and local governments' proactive approach to rescue efforts and communicating developments significantly reduces the event's negative credit effects. The Croatian government ensured HRK100 million (€13.3 million) was available for emergency repairs by revising the 2020 budget, and allocated an additional HRK41 million from the Environmental Protection Fund. Additionally, the Croatian government and the World Bank reached an agreement on a €183.9 million loan and negotiations are underway for a loan from the Council of Europe Development Bank.

Croatia will also use part of €400 million of Cohesion Policy funds provided as part of the European Union's (EU) Coronavirus Response Investment Initiative to address the earthquake's effect on the country's healthcare system, which is under strain. As an EU member state, Croatia is entitled to receive financial aid from the EU Solidarity Fund amounting to around €600 million, with additional multilateral assistance likely.

Zagreb will face financing pressure as immediate funding of emergency services and infrastructure repairs squeeze its positive operating margin of 10% of operating revenue and cash reserve of 5% of operating revenue. In the latest revision of the budget, the city committed an additional HRK114 million to the earthquake relief fund for emergency repairs. Additionally, the city's revenue will likely decline significantly this year because of the coronavirus pandemic.

We expect the national government to bear most of the costs of reconstruction at the local level, but some of Zagreb's expenditures may not be reimbursed, which would raise its debt ratio from its currently low 23% of operating revenue. However, we expect that the total increase in debt will remain moderate reaching 27% of operating revenue by 2021. Coordinated national and international humanitarian and financial assistance is likely to expedite the city's recovery, lower the cost of financing for reconstruction and limit a worsening of the city financing deficit to what we estimate will be 7% of total revenue this year (see exhibit). And, although the external financial commitments are positive, the disbursement of these funds will take several months. During that period, rescue and reconstruction efforts will strain administrative capacity and government finances at both the city and sovereign levels.

Recovery costs will exert some pressure on Zagreb's finances



Source: City of Zagreb and Moody's Investors Service

Gjorgji Josifov, *AVP-Analyst*
Moody's Investors Service
gjorgji.josifov@moodys.com
+420.23.474.7531

Mauro Crisafulli, *Associate Managing Director*
Moody's Investors Service
mauro.crisafulli@moodys.com
+39.02.9148.1105

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

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

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

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

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