Credit Outlook

20 August 2020

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Plaze's acquisitions will increase leverage

Originally published on 17 August 2020

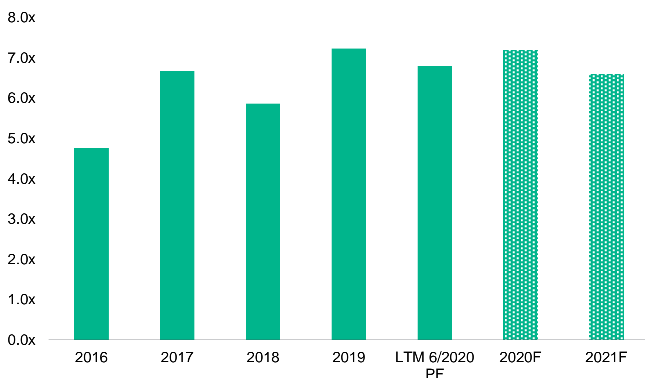
On 13 August, Plaze, Inc. (B3 stable) launched a $360 million add-on to its first-lien term loan to fund acquisitions and refinance its $82 million bridge loan. The transaction is credit negative because it will increase Plaze's financial leverage, with adjusted debt/EBITDA (leverage) rising to 6.8x on pro forma basis, from 6.5x as of June 2020. As part of the transaction, the company will also term out its $50 million revolver borrowings and increase the facility size to $100 million from $75 million.

In addition to refinancing its bridge loan and terming out its revolver, Plaze will use the funds to finance near-term acquisitions, including two under a letter of intent. These acquisitions will expand Plaze's operational capabilities and exposure in certain end-markets. This is the company's largest term loan add-on under its Pritzker ownership, with incremental debt of around $228 million. Also, the transaction and associated debt service costs will consume cash and reduce free cash flow. Even so, bolstered liquidity with $100 million of incremental revolver capacity combined with $31 million of cash and our expectation of weak but positive free cash flow generation provide sufficient risk mitigation for the company's highly leveraged balance sheet, and also current weak macro economic environment. We also perceive near-term integration and execution risk from these acquisitions as limited.

Negative implications from the global pandemic drove high single-digit declines on a year-on-year basis in Plaze's sales in the second quarter of 2020. Although weak, these results were better than our expectation thanks to sound demand from the disinfectants and cleaning products that helped mitigate weakness in more discretionary products. EBITDA contraction (on a pro forma basis) was less pronounced because of the mitigating impact from lower raw material prices. Demand rebounded, although we expect weak market conditions will continue to pressure earnings and cash generation in the second half of 2020. As a result, we expect leverage to increase to over 7.0x in 2020, before reducing in 2021 as market conditions improve (see Exhibits 1 and 2).

Exhibit 1

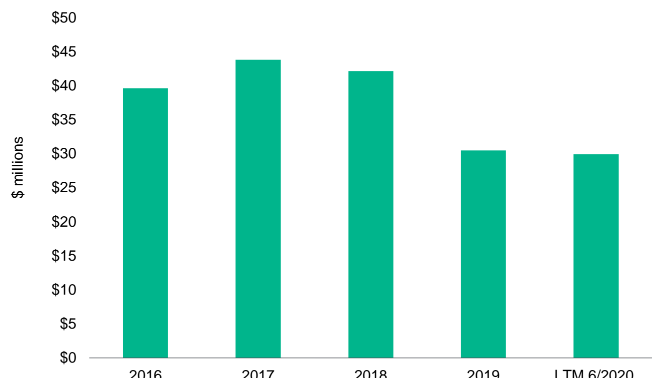
Leverage to increase and remain elevated...
Adjusted debt-to-EBITDA



[1] LTM (last 12 months) to June 2020 pro forma includes contemplated acquisitions. Historical figures are not adjusted for acquisitions.
Source: Moody's financial metrics

Exhibit 2

...though positive free cash flow and full revolver availability provide some risk mitigation
Free cash flow from 2016 until the last-12-month period that ended June 2020



Source: Moody's financial metrics

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Headquartered in Downers Grove, Illinois, Plaze is a manufacturer and marketer of specialty aerosol and liquid products including cleaners, disinfectants, lubricants, air fresheners, antiperspirants, sunscreen, polishes, adhesives and insecticides for the North American market. The company has approximately 500 proprietary formulations and serves janitorial, sanitation, industrial, automotive, paint, glass, personal care and other end markets. The company is owned by Pritzker Private Capital.

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Cencosud's long-term alliance with delivery service Cornershop is credit positive

Originally published on 15 August 2020

On 13 August, Cencosud S.A. announced a long-term strategic alliance with Cornershop, a company controlled by Uber Technologies Inc. (B2 stable). This alliance includes a collaboration for the supermarkets and home improvement operations in Chile, Peru, Colombia and Brazil. The agreement is credit positive for Cencosud because it will enhance its market position and revenue in those countries through the e-commerce business.

Cornershop is an app-based delivery service that offers same-day delivery from local grocery and specialty retailers. Cornershop was launched in 2015 in Chile and Mexico and now has a presence in seven countries in the Americas including the US and Canada. The agreement will allow Cornershop's customers to access Cencosud supermarkets like Jumbo, Wong, Metro, Santa Isabel, Prezunic and Gbarbosa, and home improvement stores like Easy in these countries free from service fees. Although Cornershop customers will continue to access Cencosud's competitors stores, service fees make them less competitive within the app. Prior to the agreement, Cornershop customers faced an 18% service fee when purchasing Cencosud's products.

Cornershop does not operate in Argentina, but as part of Uber it will cover all the countries where Cencosud operates. Also, the alliance includes technology development from both companies in order to improve the business efficiency and to offer better experience to the customers. Additionally, the alliance includes an investment of $10 million from both companies to develop picking stores (dark stores) to serve demand driven by the e-commerce business in countries where Cencosud operates. This long term alliance will allow Cencosud to increase its revenues and margins in these segments.

The coronavirus pandemic has weakened many retailers in Latin America due to their exposure to the consumer demand and sentiment. Grocery retail remained resilient since the outset of the pandemic, but the severe decline in segments with more discretionary profiles prove the need to enhance e-commerce capabilities. In March 2020, Cencosud reported same store sales (SSS) increase in Chilean grocery business of 21.6% and still e-commerce sales for the segment increased 517% in April. However, performance was much weaker in Cencosud's department stores. Considered as a nonessential sector by Chilean authorities, the division was closed for months, resulting in a same-stores sales (SSS) decline of -37.4% in March 2020. However, the decline was somewhat limited by the e-commerce sales that reported a 250% increase in April. Still, even considering some acceleration during the coronavirus outbreak, the online channel represents only about 20% of total department store sales.

From a competitive standpoint, the alliance will enhance Cencosud's position as it will partner with a strong player in a market that is rapidly evolving. In Chile, Cencosud's largest market, the company faces strong competition from Walmart Inc. (Aa2 stable), the leading food retailer holding 21% market share in 2019 according to Euromonitor. Chile is also among the most advanced online grocery markets in Latin America, with e-commerce penetration been supported by the country's above average internet connectivity and wealth. Prior to the partnership with Cencosud, Cornershop partnered with Walmart, but the agreement recently came to an end, following the decision of Mexican competition authority to block Walmart efforts to acquire Cornershop. Since then, Walmart announced a partnership with Instacart and Cornershop expanded into Peru and the US.

Headquartered in Santiago, Chile, Cencosud is one of the largest retail conglomerates in Latin America, with operations in Argentina, Brazil, Chile, Peru and Colombia. The company had sales of $13.3 billion in the 12 months that ended in March 2020 and has a portfolio of operations including supermarkets, home centers, department stores, shopping malls and financial services.

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Equity issuance is credit positive for Rumo, neutral for Cosan

Originally published on 18 August 2020

On 13 August, Rumo S.A.'s shareholders approved the issuance of up to 317.25 million new common shares through a follow-on, which can increase capital up to BRL7 billion ($1.3 billion) at the 17 August share price of BRL22. The offer requires a minimum subscription of 235 million newly issued shares, which implies an equity injection of at least BRL5.2 billion. The Cosan group, including two of its holding companies Cosan S.A. (Ba2/Aa1.br stable) and Cosan Logística S.A., parent company of Rumo, would need to deploy up to BRL2.1 billion in the capital increase if it maintains its current 30.2% stake in Rumo. The capital increase still requires final approval from Rumo's board of directors, and Rumo expects to conclude it on 27 August.

The capital increase would be credit positive for Rumo because proceeds will bolster liquidity, ease risks related to an aggressive capital spending program 2020-25 and reduce adjusted gross leverage since the company intends to prepay concession fees that we consider debt-like obligations. The capitalization accelerates Rumo's deleverage and the realization of returns over invested capital, and frees up cash for undergoing and future projects and for dividend upstreams from 2022 onwards.

For Cosan the capital increase is credit neutral. In order to maintain its 1.71% direct stake in Rumo it would need BRL119 million, compared to a cash position of BRL2.2 billion in July 2020. Since Cosan and Cosan Logística announced their interest in jointly subscribing to up to BRL2 billion of shares, we believe Cosan Logística will likely finance the balance of BRL1.88 billion with debt issuance. As part of a reorganization plan announced in early July, Cosan Limited (CZZ), which currently holds the group's participation in Cosan Logística, will be replaced by Cosan as the ultimate holding company of the Cosan group and consolidate Rumo's financials when the reorganization is concluded. Given the complexity of the process we do not expect the reorganization to be fully executed before 2021.

We believe Cosan will opt to maintain its current stake at Rumo given the strategic importance of the logistics business to the group and potential dividends once the hefty investment period in the next two years has passed. The equity injection shows Cosan's support to Rumo, and Rumo's conservative capital allocation strategy and access to diverse sources of funding during the peak of its investment cycle in 2020-22.

The capital increase is part of Cosan and Rumo's strategy to reduce leverage and improve capital allocation at Rumo after the rail operator won a new 30-year sub-concession of the Central network and renewed the Paulista network concession until 2058. Mandatory investments in both networks will increase Rumo's capital spending to an average of BRL3.8 billion per year during 2020-25 from BRL1.7 billion in 2015-19, and the concession fees due throughout the concessions' term added BRL5.8 billion in debt-like obligations at Rumo's balance sheet.

To mitigate the risks associated with a large capital spending program and negative free cash flow in 2020-23, Rumo secured BRL2.3 billion in long-term funding during the first half of 2020 and issued $500 million in green bonds in July 2020. With that, Rumo's cash position is currently at around BRL8.5 billion compared to an average of BRL3.3 billion during 2017-19, which is sufficient to cover almost all debt amortizations until 2023 and fund three years of expansion capex. Total investments in the Paulista and Central networks amount to BRL8.8 billion during the lifetime of the concessions, but about half of it will be spent by 2028.

While necessary to reduce liquidity risks during the execution of investments, the additional debt and the concession fees increased Rumo's adjusted gross leverage to 7.3x (including foreign exchange variation) in the 12 months that ended June 2020 from 4.9x at year-end 2019. This leverage at Rumo would translate into adjusted leverage of about 6.6x (up from 4.2x at the end of 2019) at Cosan after the reorganization is concluded. Pro forma for the capital increase, Rumo's adjusted leverage could fall to 5.5x, while Cosan's leverage could fall to 5.9x, depending on the amount of concession fees Rumo prepays (see exhibit). If Rumo does not prepay a material amount of concession fees, its liquidity profile would improve even further with the additional cash.

Cosan and Rumo's leverage will decline with equity offer
BRL millions, as of 30 June 2020

		Rumo	Before reorganization: Cosan S.A. + Raizen (50%)	After reorganization [2]: Cosan S.A + Raizen (50%)
Adjusted gross debt [1]		28,635	34,482	68,343
Adjusted EBITDA (LTM)		3,932	6,393	10,325
Gross debt/Adjusted EBITDA		7.3x	5.4x	6.6x
Gross debt ex-FX/Adjusted EBITDA		6.5x	5.1x	6.0x
Pro forma leverage considering different use of proceeds [3]:				
25% of proceeds to pay concession fee	Min	7.0x	5.2x	6.5x
	Max	6.8x	5.1x	6.5x
50% of proceeds to pay concession fee	Min	6.6x	5.0x	6.4x
	Max	6.4x	4.8x	6.3x
75% of proceeds to pay concession fee	Min	6.3x	4.8x	6.2x
	Max	6.0x	4.6x	6.1x
100% of proceeds to pay concession fee	Min	6.0x	4.6x	6.1x
	Max	5.5x	4.3x	5.9x

[1] Pension, refinancing program, lease and concession liabilities, related parties; [2] after the reorganization process, Cosan S.A.'s financials will include Cosan Limited and Cosan Logisticas' figures; [3] capital increase: minimum amount of BRL5.2 billion and maximum amount of BRL7 billion.
Sources: Cosan and Rumo's financials and Moody's Investors Service

Even though we consider concession fees as debt-like obligations, the associated cash outlays are spread over more than 30 years, collectively representing an outflow of about BRL750-900 million per year for Rumo, or about 20% of its annual EBITDA. Rumo's adjusted gross leverage excluding the concession adjustments will remain at around 3.5x, the same level since 2017, and reported net leverage, which is used for covenant measure, will remain near 2.0x in 2020-21.

Rumo is the largest independent rail-based logistics operator in Latin America, managing five long-term rail concessions totaling approximately 13,470 kilometers of rail tracks, about 1,200 locomotives and over 33,000 railcars, through which the company transports agricultural commodities and industrial products. Cosan is a holding company with relevant stakes in Raízen Energia S.A. (Ba1/Aaa.br stable), one of the leading global companies in the sugar-ethanol segment, Raízen Combustíveis S.A. (Ba1/Aaa.br stable), Brazil's second-largest fuel distributor, and Cia de Gas de Sao Paulo - Comgás (Ba1/Aaa.br stable), Brazil's largest natural gas distributor. Additionally, Cosan produces and distributes automotive lubricants and base oil under the Moove brand.

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Diageo's acquisition of super-premium gin brand is credit negative despite its small size

Originally published on 19 August 2020

On 17 August, UK-based spirits maker Diageo Plc (A3 stable) announced its agreement to acquire Aviation American Gin through the acquisition of Aviation Gin LLC and Davos Brands LLC. Diageo will pay a total consideration up to $610 million, including an initial payment of $335 million and a potential payment of up to $275 million based on the performance of Aviation American Gin over a 10-year period. Diageo will fund the acquisition through existing cash and expects it to close before year-end, pending regulatory clearances.

Although leverage will remain unchanged given the acquisition's small size relative to Diageo's operations, the acquisition is credit negative because it occurs while leverage remains relatively high as debt metrics have substantially weakened as lockdown measures dampened global spirits consumption, thus lowering the company's sales and profits.

In fiscal 2020, which ended 30 June, Diageo's leverage, measured in terms of Moody's-adjusted gross debt to EBITDA. deteriorated to 4.2x from 3.0x in the 12 months to 31 December 2019, and we expect leverage will further increase and likely peak in the first half of fiscal 2021, remaining well above the 2.75x-3.25x range we expect for its A3 rating. Our current base case currently assumes a gradual recovery as trade restrictions on restaurants and bars ease and debt maturities are repaid. However, further acquisitions or the resumption of share buybacks could constrain leverage improvement. The acquisition of Davos Brands will be leverage-neutral in terms of gross debt since it will be funded with existing cash balances, independently from the (undisclosed) amount of acquired EBITDA. On a net debt basis, leverage is around 3.6x if measured on a Moody's adjusted net debt basis and the acquisition will only marginally raise this ratio by around 0.1x.

Indeed, Diageo's M&A has been quite active over the past three years. In 2017 the company bought Casamigos, a UK luxury tequila brand, for $1.0 billion, of which $300 million was contingent on Casamigos achieving certain performance targets. Before that, during 2013 and 2014, Diageo paid £1.8 billion for a 54% in United Spirits, an Indian company, and has subsequently increased its shareholding to 55.94%. All the acquisitions were a good fit with Diageo's portfolio and help the company position itself in new product categories, geographies or price points where it is underexposed. But the acquisitions were also at high purchase multiples, reflecting the acquired businesses' expected growth and perceived brand strength. Additional sizeable acquisitions could stretch Diageo's debt metrics.

Diageo's liquidity remains strong overall because it has taken precautionary measures to strengthen it, including pausing share buybacks, raising more debt and putting in place an additional committed credit facility of £2.5 billion, which was undrawn as of 30 June. At the same date, the company had £3.3 billion cash on balance sheet (or £2.6 billion pro-forma for the repayment of £696 million of bonds in July), up from £950 million at the end of December. The next bond maturities are €775 million due in November 2020, €900 million in October 2021 and $1 billion in May. The announced acquisition is small and will only marginally dent Diageo's liquidity, although additional acquisitions could change this.

More positively, the acquisition will strengthen Diageo's brand portfolio, adding to its the super-premium gin segment in the US and growth potential, albeit at a price. Through the acquisition, Diageo is also acquiring the other brands in the Davos Brands' portfolio: Astral Tequila, Sombra Mezcal and TYKU Sake. According to Diageo, Aviation American Gin is the second largest and one of the fastest growing brands within the super-premium gin segment in the US, and doubled its sales volumes in 2019 as well as its market share of the gin category in the last five years with compound annual growth rate of 18.5% over the same period.

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Avast's second-quarter revenue spiked amid COVID-19 remote working

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On 12 August, Avast Software B.V. (Ba2 stable) reported a solid second quarter, which ended 30 June, in spite of the effects of the coronavirus outbreak and privacy issues earlier this year. Additionally, the company voluntarily repaid $100 million of debt, a credit positive. The increased incidence of people working from home amid the pandemic lockdown measures fostered increased demand for cybersecurity solutions.

Avast's revenue increased by 1.5% while its second-quarter Moody's adjusted EBITDA-margin declined to 49% from 52% in second-quarter 2019. The decline was primarily driven by extraordinary effects from the Jumpshot transaction as well as company donations to fight the coronavirus outbreak. The company repeatedly used it strong free cash flow generation to voluntarily repay outstanding debt reducing Moody's-adjusted leverage to 2.2x in the 12 months that ended 30 June 2020 from 2.5x in 2019. Before extraordinary expenses leverage (Moody's adjusted) would have been at 2.1x.

In January Avast's reputation was sullied by its subsidiary Jumpshot that sold customer data to third parties. Following these reputational issues and the immediate closure of Jumpshot thereafter, the company's installed base swiftly recovered from a short dip after the incident. The main reason was an increasing need for higher privacy and cybersecurity solutions across many countries as many employees shifted to remote working due to lockdown measures from the coronavirus pandemic.

Avast was able to convert a higher share of its more than 400 million users of the free version of its software into paying customers. Especially the consumer desktop segment, with 78% of total revenue the main segment, showed a strong organic growth of 9% in the first half of 2020 compared to last year. While the consumer indirect segment grew organically by 6%, Avast's consumer mobile business segment declined organically by 4% and its small and medium-sized business (SMB) segment declined organically by 7%. The Consumer Indirect segment, unchanged, struggles with the loss of major carriers while SMB was in line with expectations but could experience a higher decline going forward as the economic situation weakens.

Avast continuously has grown revenue and EBITDA for several years from the rising demand of cybersecurity solutions fostered by the working-from-home spike during lockdown measures. While lockdown measures have generally been reduced since the general measures earlier this year, we nevertheless expect long-term rising demand for the company's software absent such one-off effects. However, even if employees continue to work remotely, we expect a risk of increasing competition by enterprise solutions once employers have introduced formal remote working policies.

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Helios Towers' acquisition in Senegal diversifies and strengthens its revenue base

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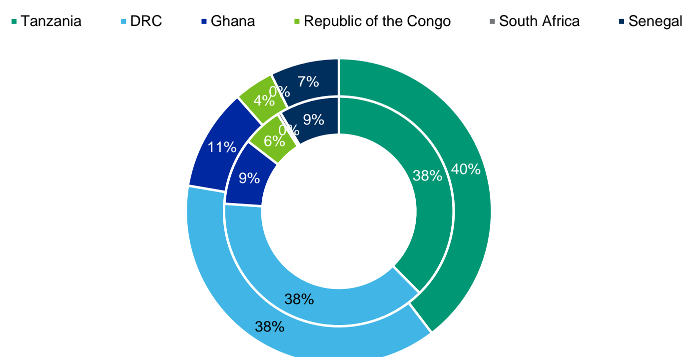
On 12 August, Helios Towers plc (HT, B2 stable), a leading independent tower operator in several African countries, announced that it agreed to acquire 1,220 towers from Free Senegal, the second-largest mobile operator in Senegal (Ba3 negative) by number of subscribers, for €160 million ($189 million) in cash. Pending regulatory approvals, the company expects the deal to close in the first quarter of 2021.

The purchase is credit positive because it gives HT a sizable presence in a new market, diversifies its customer base and increases its exposure to a higher-rated sovereign market. The diversification benefits outweigh the marginally higher gross leverage resulting from the transaction.

A presence in Senegal exposes HT to a less risky sovereign market than in its mostly lower-rated existing core markets of Tanzania (B1 negative), Republic of the Congo (Caa2 stable), Democratic Republic of the Congo (DRC, Caa1 stable), Ghana (B3 negative) and South Africa (Ba1 negative). The Senegal operation will become HT's fourth-largest revenue and EBITDA contributor, behind the Democratic republic of Congo, Tanzania and Ghana, as shown in the exhibit. In addition, Senegal is one of eight countries that use the CFA franc, whose peg to the euro is guaranteed by the Government of France (Aa2 stable). As a result, the acquisition will increase HT's exposure to more stable dollar and euro-pegged cash flows to 63% of revenue from 59% as of 30 June 2020.

Entry into Senegal diversifies operational cover to six African countries
Pro forma revenue split (inner circle) and pro forma EBITDA split (outer circle)



EBITDA split excludes central corporate costs
Source: Company's second-quarter 2020 presentation

With cash of $213 million and a $200 million undrawn term loan as of 30 June, HT has sufficient liquidity to fund the $189 million purchase price. We expect leverage to increase marginally and remain well within management's financial net debt/EBITDA (pre-IFRS 16) target of 3.5x-4.5x. Assuming a 50:50 funding split between cash and debt, pro forma gross debt/EBITDA would increase to 4.2x from 4.1x on a Moody's-adjusted basis as of 30 June, and pro forma adjusted net leverage would increase to 3.7x from 3.1x.

The acquisition will immediately generate operational cash flow given HT's 15-year service contract with Free Senegal but may require additional funds to build new towers. Upon closing, the company expects the Senegal operations to initially generate a run rate of $38 million revenue and $19 million EBITDA (index-adjusted per year), and be initially margin dilutive compared with the HT's current EBITDA margin of 54%.

The tower acquisition will give HT the second-largest tower portfolio in Senegal, or around 30% of the total tower market, behind number one mobile operator, Orange, owning over 50% of the Senegal tower market. With a strong urban presence (70% of towers are in urban locations) in Senegal, HT's tower portfolio is well positioned to benefit from the densification of the network as 4G is rolled out. As of year-end 2019, Senegal had a low 4G penetration rate of around 17% of subscribers. In addition, as the only independent tower operator in Senegal, HT will be able to use its existing 1,220 towers to attract other mobile operators (Sonetal Orange and Expresso) and improve the tenant co-location per tower toward 1.5x from 1.0x over the next five years, in doing so improve the EBITDA margin.

As a private company, Free Senegal's credit quality is unknown. However, the mobile operator has a sizable market position with a 26% share of subscribers and the backing of a consortium of African focused private-equity shareholders (Teyliom, NJJ and Axian). Free Senegal was rebranded in October 2019 (from Tigo Senegal) and we understand it has committed to CFA70 billion ($126 million) of planned investments to grow its 4G+ network.

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BNDES' first-half loan disbursements increased, a credit positive

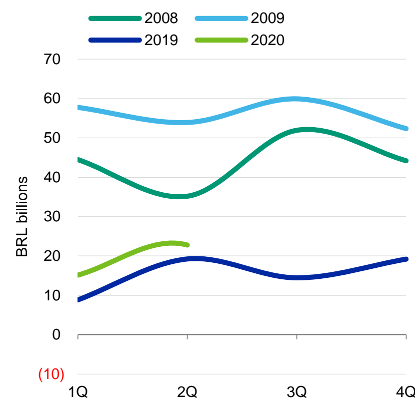
Originally published on 18 August 2020

On 14 August, Banco Nacional de Desenvolvimento Economico e Social - BNDES (Ba2/Ba2 stable, ba2[1]) reported increased lending activity and a year-over-year first-half increase in loan disbursements for the first time since 2013, a credit positive.

The increase from pre-pandemic loan activity is credit positive and fits BNDES' operations more closely with its traditional development bank role. The recovery of BNDES' loan disbursements in first-half 2020 reflects its countercyclical role supporting micro, small and midsize enterprises (SMEs) during the coronavirus pandemic. Loans disbursed to SMEs increased 11% in the first-half 2020 over the same period of 2019, now representing 49% of total loans disbursements, three percentage points higher than a year before.

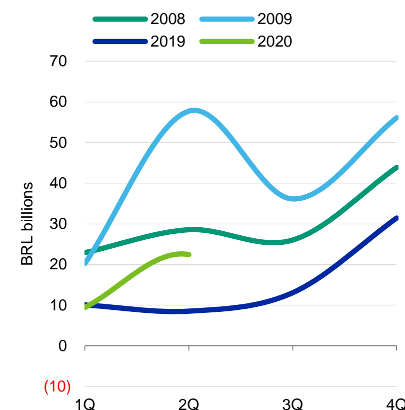
BNDES' first-half loan disbursements increased 3.4% from first-half 2019 (Exhibit 1), loan application volume rose 35% and approvals increased 72% versus first-half 2019 (Exhibits 2 and 3). First-half 2020 disbursements equated to 49% of loans originated in the second half of 2008, showing a more disciplined use of the balance sheet and cautious approach to lending than at the beginning of the 2008 global financial crisis.

Exhibit 1
Both the volume of loans consultations...



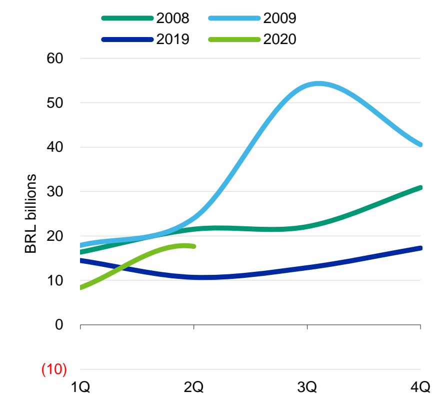
Sources: BNDES and Moody's Investors Service

Exhibit 2
... approvals ...



Sources: BNDES and Moody's Investors Service

Exhibit 3
... and disbursements recovered in first-half 2020, but are still far from past global financial crisis



Sources: BNDES and Moody's Investors Service

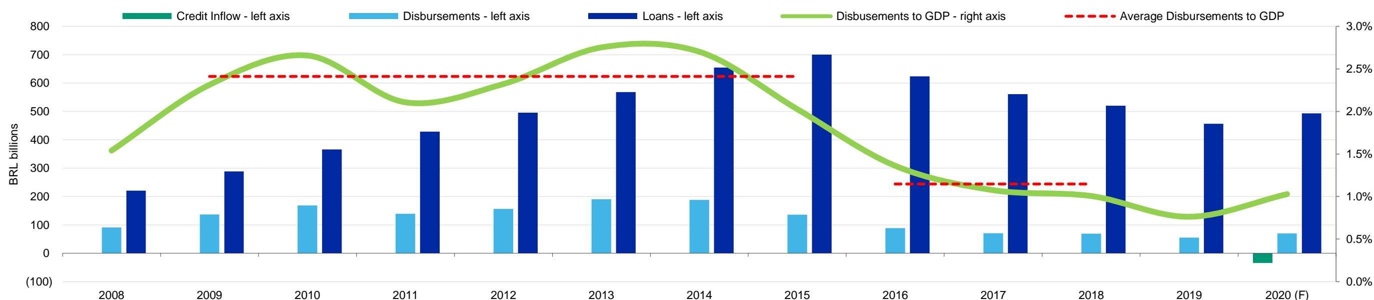
We expect that loans will have lower importance than in the past, whereby the bank boosted subsidized loans to large companies. In the second half of 2008, for instance, the volume of loan disbursements increased 32% from the year before, but 77% of the loans were to large companies. This year, first-half loan disbursements to large companies fell 3% to 51% of total loans. BNDES has partnered with other banks to be the main financing provider for those companies, and also granted loans for this segment at market rates.

Of BNDES' BRL 92.1 billion of revised measures to combat the coronavirus, with nearly 65% executed by mid-August, it has acted beyond its financing role. It has been the conduit of the National Treasury for some of the programs. Those include Programa Emergencial de Acesso ao Crédito (PEAC), whereby BNDES manages a federal investment guarantee fund to provide credit to SMEs and Programa Emergencial de Suporte a Empregos (PESE), in which the bank manages a credit line to finance payroll expenses of SMEs, out of which 85% refers to resources granted by the National Treasury. BNDES has also used credit fintechs to offer credit and to securitize loans to investments funds, and has accessed supply chains companies to enhance credit flow among micro, small and medium companies.

Within this new approach, we expect that BNDES' loans originations will equate to around 1% of GDP in 2020, up from its low 0.76% share in 2019 but still well below the 2.4% average 2009-15 (Exhibit 4).

Exhibit 4

We expect loans disbursements will increase to 1% of GDP in 2020, from 0.76% share in 2019



Sources: BNDES, Central Bank of Brazil and Moody's Investors Service

The bank's on balance sheet gross credit portfolio was BRL462 billion in the first-half 2020, up 1.4% from year-end 2019, but 4.6% below first-half 2019. Of the BRL168 billion loans renegotiated in the period, equal to 36% of gross loans, 86% had six-month loan repayment deferrals. Those loan moratoriums are part of the aggregate BRL17.4 billion revised standstill program for installments of direct loans, public sector and loans granted through financial intermediates. Non-performing loans reduced to 0.46% of gross loans in the first-half 2020, down from 2.77% in December 2019, but will likely weaken in the event of a more prolonged economy slowdown and declining borrowers repayment capacity after the end of deferral periods. The bank strengthened loan-loss provisions by BRL2.3 billion in the first-half 2020.

Endnotes

1 The ratings shown are BNDES' deposit rating, senior unsecured debt rating and Baseline Credit Assessment.

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Political tension in Belarus prompts retail deposit withdrawals from banks, a credit negative

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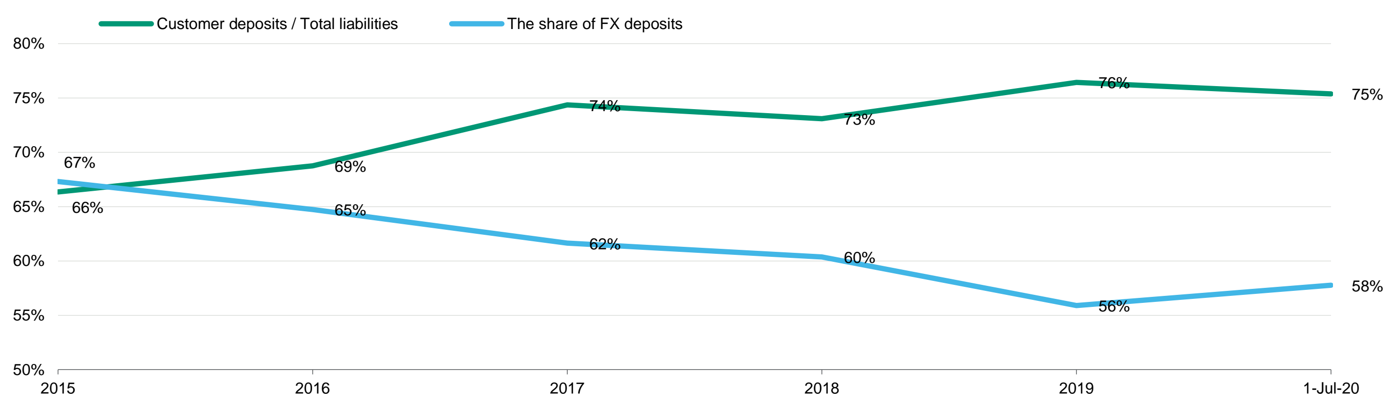
On 12 August, the Belarus (B3 stable) central bank, the National Bank of the Republic of Belarus (NBRB), said that banks' retail depositors increased withdrawals and moved cash savings to foreign currencies from the Belarusian ruble after presidential elections on 9 August increased political uncertainty.

The outflows are credit negative because they weaken banks' liquidity cushions and funding profiles. Customer deposits are the banks' dominant funding source and comprised 75% of systemwide liabilities as of 1 July. Foreign-currency (FX) deposits, mostly in US dollars, accounted for a high 58% of total system deposits as of the same date and are particularly sensitive to changes in depositor sentiment (see Exhibit 1).

Exhibit 1

Belarus banks rely significantly on FX-denominated deposits for funding



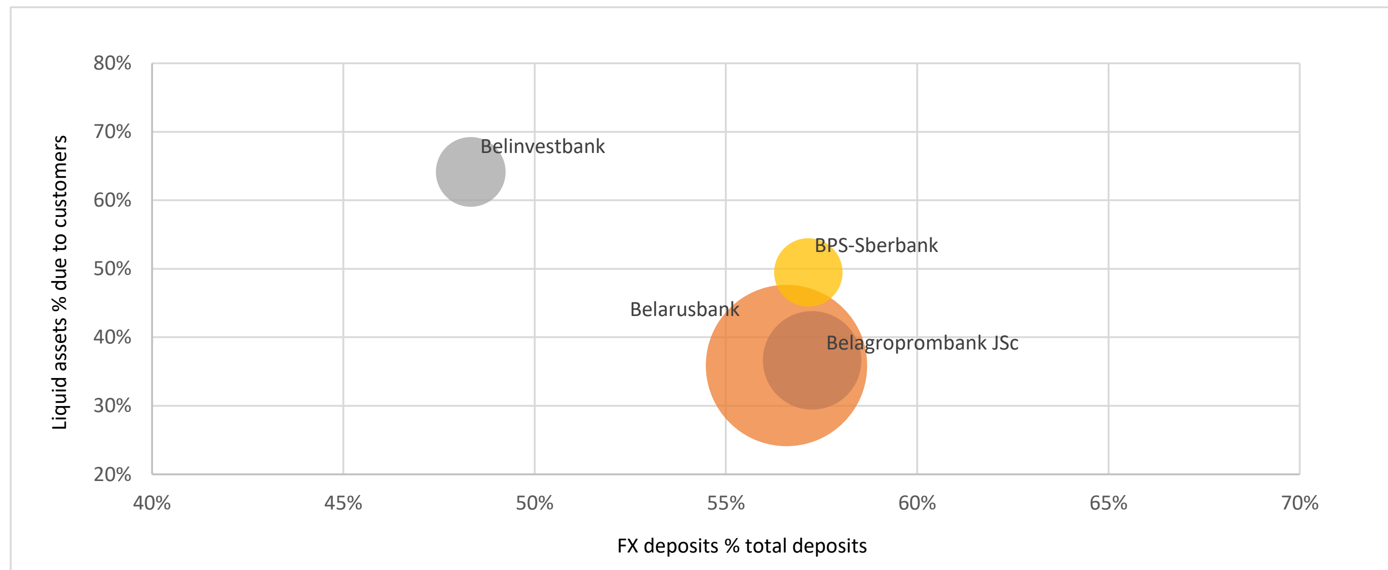
Source: NBRB

Belarus banks' large liquidity cushions provide a solid defense against deposit withdrawals. For the four Belarus banks which we rate, liquid assets exceed 40% of their combined customer deposits. However, currency and maturity mismatches pose risks because foreign-currency liquid assets covered only about 60% of the banks' foreign-currency short-term liabilities at year-end 2019[1]. Also, the NBRB is less able to support the banking system with FX liquidity because the sovereign has modest foreign-currency reserves: these comprised just 23% of systemwide FX liabilities as of 1 August[2].

Among the largest banks in Belarus that we rate, Belinvestbank (B3 stable, caa1[3]) has the highest liquidity cushion relative to customer deposits, as well as the lowest share of volatile FX deposits (see Exhibit 2). The combination of factors enhances its standalone resilience to deposit outflows. While Belarusbank (B3 stable, b3) and Belagroprombank JSC (B3 stable, caa1) have lower liquidity cushions compared to peers, covering 36%-37% of customer deposits, they benefit from a very high probability of state support given their largest market shares in the country. Similarly, BPS-Sberbank (B2 stable, b3) has access to liquidity support from its parent, Russia's Sberbank (Baa3 stable, ba1), in case of need.

Exhibit 2

Belinvestbank's high liquidity cushion and lowest share of FX deposits enhance its resilience to deposit outflows
Year-end 2019



For Belarusbank, the share of foreign-currency deposits in total deposits is estimated, based on the total amount of FX deposits at state-owned banks (as per NBRB) and IFRS data for the other two state-owned banks (Belagroprombank and Belinvestbank).
Sources: banks' IFRS reports and regulatory filings, Moody's Investors Service

Endnotes

1 Our estimate is based on IFRS data for three out of four rated banks (except Belarusbank).

2 Our calculation excludes the less liquid gold from the total reported amount of reserves.

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

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Aareal's sale of stake in subsidiary will increase its capital buffers

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On 14 August, Aareal Bank AG (A3/A3 negative, baa3[1]) announced the sale of a 30% minority stake in its fully owned IT and service subsidiary Aareon AG to Advent International for approximately €260 million. Aareal expects a capital gain of €180 million, which will increase its capital buffers, a credit positive in the current adverse economic environment and in light of its exposure to the higher-risk commercial real estate (CRE) sector.

The transaction corresponds to an equity value for Aareon of approximately €860 million and an enterprise value of €960 million. As a result, Aareal will have valuation reserves of approximately €420 million in its remaining 70% stake in Aareon, in addition to the €180 million that the stake sale unlocked. Together with Advent, Aareal will attempt to accelerate Aareon's growth and earnings potential, and has combined revenue growth and EBITDA margin improvement targets of 40% by 2025, limiting or even outweighing potential earnings dilution from the sale.

The net capital gain of approximately €180 million at closing, which Aareal expects in the fourth quarter of this year, equals 7.8% of its €2.3 billion existing Common Equity Tier 1 (CET1) capital as of 30 June 2020, increasing the bank's CET1 ratio to 21.3% of risk-weighted assets from 19.8%. Further positive effects on capital this year stem from higher retained earnings following the European Central Bank's dividend ban and Aareal's decision to refrain from exercising the call option on its €300 million high-trigger Additional Tier 1 notes on 20 March.

The resulting substantial improvement in Aareal's capital buffers provides a significant and rising cushion for credit risks from its €25.6 billion CRE portfolio. Aareal's exposure to higher-risk sectors such as tourism and leisure[2] through the financing of hotel properties (34% of the portfolio as of 30 June 2020) and retail[3] (23%), both asset classes which have been particularly hard-hit by the coronavirus pandemic, is pressuring earnings and asset quality. This pressure is reflected in increased credit risk costs of approximately 80 basis points on an annualised basis for the first half[4] and a significantly declining yield of 4.5% on debt for Aareal's hotel portfolio as of 30 June 2020, down from 9.6% at year-end 2019.

Endnotes

1 The ratings shown are Aareal's deposit rating/issuer rating and outlook, and its Baseline Credit Assessment.

2 See **Limited immediate negative credit impact of coronavirus, substantial downside risk**, 16 March 2020.

3 See **Credit quality weakens as coronavirus exacerbates sector's structural challenges**, 15 April 2020.

4 See also **German property-lending banks report first-half profits despite boosting loan loss provisions**, 17 August 2020.

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Democratic Republic of Congo's key rate increase will weigh on banks' profitability

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On 14 August, the Democratic Republic of the Congo (DRC, Caa1 stable) central bank materially increased its benchmark interest rate to 18.5% from 7.5%. The 1,100 basis point (bp) key policy rate increase is credit negative for DRC banks because it will weigh on their profitability by increasing the cost of meeting their regulatory reserve requirements in the local currency.

Given the high dollarisation in the DRC banking system, the level of the central bank's benchmark interest rate has limited effect on banks' deposit gathering and lending activities because the rate only influences local currency assets and liabilities. In DRC, 95% of loans and 87% of deposits were denominated in foreign currency (predominantly in US dollars) as of June.

As per local regulation, DRC banks' current accounts at the central bank must hold a minimum amount of local currency reserves, which is calculated as a proportion of each bank's deposits base. Given that DRC banks primarily fund themselves through foreign currency deposits but must meet their reserve requirement in local currency, they typically buy the required local currency from the central bank or the interbank market at a rate influenced by the central bank's benchmark interest rate. Consequently, a higher benchmark rate increases the cost that banks incur in constituting their reserve requirement. The reserve requirement ratio for DRC banks equals 13% of their foreign currency demand deposits, 12% of their foreign currency time deposits and none for their local currency deposits.

The benchmark interest rate increase follows the Congolese franc's 17% depreciation against the US dollar this year and an increasing rate of inflation in commodity-exporting DRC, amid weaker global economic activity and lower commodity prices. We estimate that the inflation rate was 5.5% in 2019 and the central bank reported that the year-on-year inflation rate as of July this year was 14.6%. The central bank forecast that in unchanged conditions, the inflation rate could increase to 20.8% at the end of the year.

We expect the coronavirus pandemic to significantly weigh on the DRC's economic activity, reflecting the country's high vulnerability to external shocks and terms-of-trade shocks because of its reliance on commodity exports and on external funding. Minerals and metals account for more than 80% of DRC's exports.

The coronavirus pandemic will materially reduce DRC banks' profitability as repayment relief for affected borrowers reduces interest income and lower business transactions weigh on fee income. In addition, loan-loss provisioning will materially increase as the economic effects of the outbreak weaken borrowers' repayment capacity. We estimate that systemwide return on assets was 1.1% during 2018.

The incidence of dollarisation in the economy and banking system primarily reflects the population's fragile confidence in the local currency following hyperinflation in the 1990s, and high inflation in 2009 (53%) and 2017 (55%). It also reflects the importance of commodities to the DRC economy, with large mining and oil exports that tend to be invoiced in US dollars.

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ICICI Bank's equity raise will strengthen capital position, a credit positive

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On 15 August, ICICI Bank Limited (Baa3 negative, ba1[1]) announced that it had completed the allotment of shares under its qualified institutional placement (QIP) and raised INR150 billion ($2 billion) in equity capital.

The allotment is credit positive for ICICI Bank because it will improve its capital position. This is an important development because the ongoing economic slowdown exacerbated by the disruptions from the coronavirus outbreak, will have a negative effect on the bank's asset quality and pressure profitability and capital.

We estimate that the capital raise will result in a 170 basis points in the consolidated Common Equity Tier 1 (CET1) ratio from 13.4% at the end of June 2020, after including profit for the June quarter.

In addition to this equity raise, the bank also raised additional capital through a part sale of its subsidiaries. In June 2020, it sold a 1.50 percentage point stake in ICICI Prudential Life Insurance and a 3.96 percentage point stake in ICICI General Life Insurance, collectively raising INR30.9 billion. The bank still retains majority ownership in these two entities.

The bank has also been making forward-looking credit provisions for potential asset-quality stress driven by the coronavirus driven economic disruption. Such provisos now amount to 1.3% of loans, which is amongst the highest within the rated Indian banks

Although the countrywide lockdown in India has been lifted, economic activity is still subdued, and daily infections of coronavirus remain high. As a result of these disruptions, we estimate that GDP in fiscal 2020 (ending March 2021) will contract by 4%. This will be the weakest economic performance in the past four decades and will have a significant near-term effect on the cash flow of bank borrowers and, consequently, their ability to repay loans.

We expect that the most affected loan segments will be retail and small and medium-sized enterprises. As is the case with other rated private sector banks, ICICI has a large exposure to retail loans which account for 63% of its loan book, including agriculture loans, a key risk.

The enhanced capital buffers will support the bank's credit profile in these times of economic uncertainty. Additionally, the bank's core profitability buffer remain strong with pre-provision income (adjusted for one-off gains) for the quarter ending June 2020 at 2.5% (annualized). The bank also has profitable stakes in its subsidiaries, most notably in insurance companies, which can be liquidated if unforeseen capital needs arise, although this is not part of our basecase scenario.

Endnotes

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

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Proposal allowing Brazilian insurers to issue subordinated debt is credit positive

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On 13 August, Brazil's insurance regulator, Superintendência de Seguros Privados - SUSEP, launched a request for comment (until 14 September) on a proposal to allow insurers to issue subordinated debt. The consultation is credit positive because it will allow insurers to improve their financial flexibility, boost liquidity and lower cost of capital, increasing the alignment of the Brazilian market to international standards for insurers.

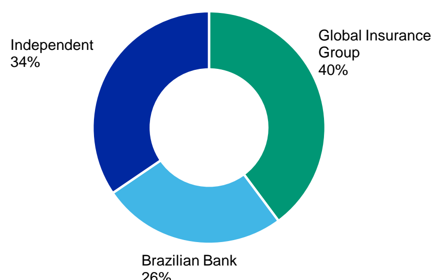
The proposal would allow issuance of a type of hybrid capital, expanding financing sources for the insurers. Given their subordination and loss absorption characteristics, these instruments will be eligible as regulatory capital for insurance companies. Consequently, insurers will be able to improve their capitalization and support business growth without issuing straight equity.

In addition to reducing leverage by adding to the equity content of a balance sheet, a hybrid issue can benefit an issuer's capital structure by improving liquidity and diversifying a company's investor base. Also, hybrids can replace equity issuance, giving insurers with limited or no access to capital markets an alternative funding source.

The issuance of hybrid instruments can also lower a company's cost of capital usually to between the cost of equity and debt. The hybrid's cost and its effect on the issuer's overall cost of capital will depend on whether it is closer to the cost of equity than a 50% debt component would imply, or closer to the cost of debt than a 50% equity element would imply. Therefore, if companies start loading up their balance sheets with debt, it would be negative for their credit profiles because their cost of capital and debt service would increase.

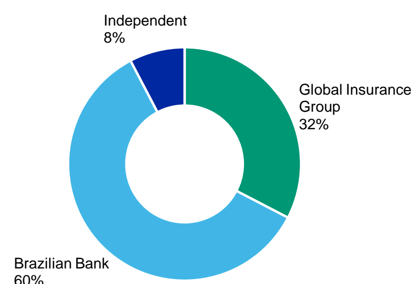
Although the proposal would benefit the whole Brazilian insurance market, the 34% of Brazilian companies that do not have direct access to capital markets or capital injections from domestic or international parents would benefit the most, suggesting that the new source of financing has potential to develop (Exhibit 1).

Exhibit 1
Distribution of insurance companies by affiliation
34% of insurance companies in Brazil do not benefit from support...



Only companies that issued premiums in 2020 are being considered.
Sources: SUSEP and Moody's Investors Service

Exhibit 2
Share of gross premium written by affiliation
... in terms of industry premiums, this number drops to 8%.



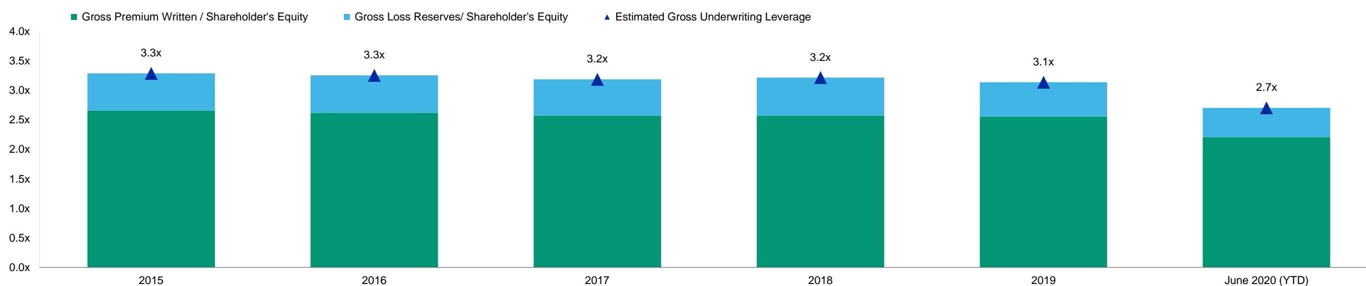
Only companies that issued premiums in 2020 are being considered. Share of gross premiums as last twelve months to June 2020.
Sources: SUSEP and Moody's Investors Service

Although Brazilian insurers have generally maintained sound capitalization levels (Exhibit 3), the proposal comes as insurers are challenged to generate capital internally because premiums are expected to decrease, delinquencies from existing policies to increase and investment results have been affected by lower interest rates, which will prolong the time needed to reinvigorate the economy.

Exhibit 3

Insurance companies' capitalization metrics

Insurance companies operating in Brazil have shown sound capitalization levels



June 2020 estimated underwriting leverage has been lower because of lower premiums as a consequence of the coronavirus confinement.
Sources: SUSEP and Moody's Investors Service

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Delay in fiscal support is negative for US economy and consumer-facing sectors

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On 14 August, the US Senate adjourned for its summer recess without reaching agreement on a new coronavirus relief package, a credit negative. While negotiations face big hurdles, we expect Congress to ultimately pass legislation that replaces, at least to some degree, the recently expired relief measures for the unemployed and other segments of the economy still reeling from the pandemic. However, the delay in new support will dent unemployed workers' purchasing power and ability to meet financial obligations, negatively affecting consumer-facing sectors such as retail, rental housing and consumer finance.

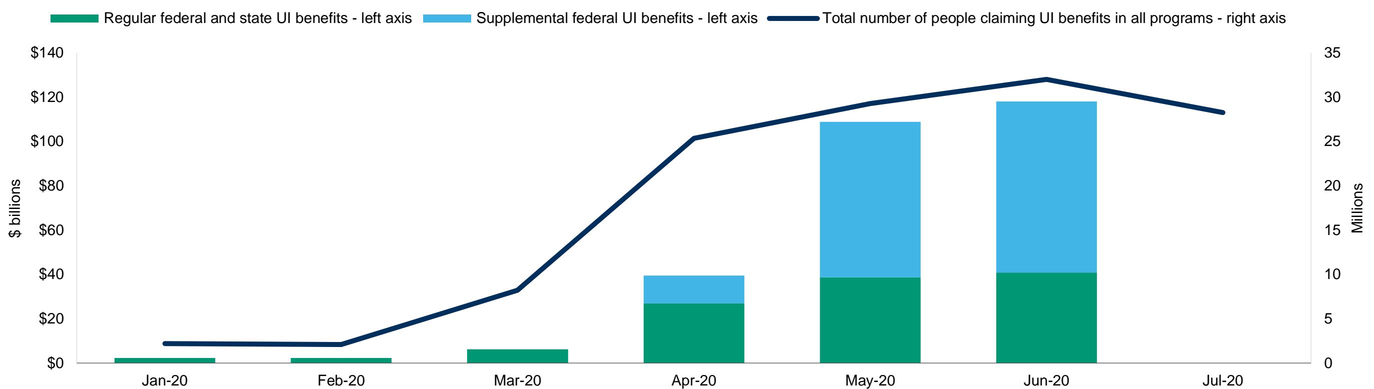
For state and local governments, the reduced consumption and financial hardship of the unemployed could further dampen tax revenue and increase spending on social safety net programs, exacerbating budgetary pressures. And while President Donald Trump's recent executive actions provide pandemic relief, they are subject to implementation risks and their limited scope is unlikely to offset the ongoing damage to economic activity from the pandemic.

The expiration of the $600 in weekly supplemental unemployment insurance (UI) benefits at the end of July constituted an income cliff for the nearly 30 million workers currently collecting jobless benefits. Supplemental UI benefits totaled more than $70 billion in both May and June, accounting for more than 60% of the total UI benefits that federal and state unemployment programs provided (see Exhibit 1).We expect the effects to ripple across the economy**.**

Exhibit 1

Supplemental benefits have accounted for large share of total UI benefits

Monthly UI benefits spending by program and number of people claiming benefits



Sources: US Department of Labor, US Bureau of Economic Analysis and Moody's Investors Service

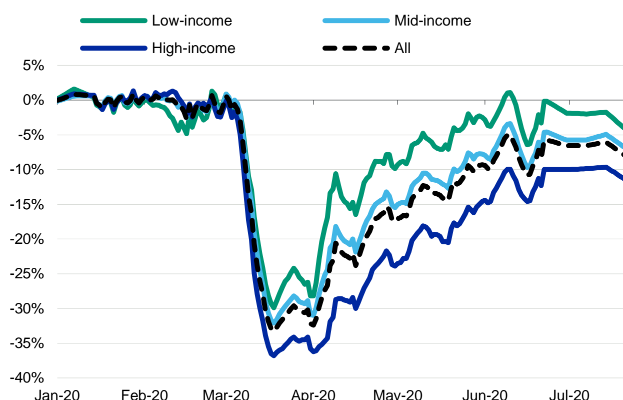
The supplemental benefits have supported consumer spending. Job losses have disproportionally affected low-income workers, who have a higher propensity to consume than do middle and high-income households. High-frequency consumption data and survey results show that households have mainly used unemployment benefits and other safety net transfers to meet current spending needs, supporting a consumption rebound for lower-income households since mid-April (see Exhibit 2).

With the expiration of this additional support, affected households will likely reduce discretionary spending and could also lower consumption of non-discretionary goods and services. The effect on US (Aaa stable) GDP may be muted in the short term because lower-income households account for a relatively small share of overall consumer spending (see Exhibit 3). But if the pullback in consumption continues for a longer period, the effect would accumulate and temper the economic recovery.

Exhibit 2

Spending by low-income households has nearly recovered to pre-pandemic levels

Household spending by income level relative to January 2020

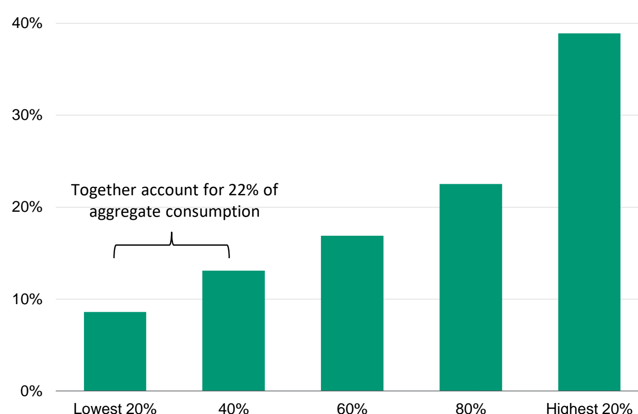


Sources: Opportunity Insights Economic Tracker, and How Did COVID-19 and Stabilization Policies Affect Spending and Employment? A New Real-Time Economic Tracker Based on Private Sector Data, by Raj Chetty, John Friedman, Nathaniel Hendren, Michael Stepner and the Opportunity Insights Team, June 2020

Exhibit 3

Bottom 40% of households by income account for around a fifth of aggregate consumer spending

Shares of annual consumer expenditure by quintile of income, 2018



Income is before taxes.

Sources: US Bureau of Labor Statistics and Moody's Investors Service

In addition to the broader impact on consumption, there may be effects on other areas of the economy, such as rental housing. The withdrawal of supplemental UI benefits also coincides with the end of eviction moratoriums for renters that the federal government and certain state and local authorities put in place at the outset of the pandemic. Some localities have extended their moratoriums but others have not, putting some households that have lost supplemental benefits and cannot make rent payments at particular risk of eviction. In the US Census Bureau's latest weekly Household Pulse Survey, published on 29 July, roughly a third of respondents reported having “no” or “slight” confidence in their ability to pay the next month's rent. An eviction procedure in itself can increase financial fragility for affected households because it can make it more difficult to find housing in the future.

Similar to the challenges of making rent payments, the end of supplemental UI benefits will likely also spur more delinquencies in consumer credit payments, especially for non-prime auto, personal and credit card loans. Delinquencies were already poised to rise as loan extensions and other payment relief programs expire. However, the change in unemployment benefits may result in lenders extending additional borrower relief, which is likely to be less generous than during the first round. Banks have already set aside significant provisions in anticipation of future credit losses, even as the combination of fiscal support to households and lenders' forbearance programs have kept the rate of new consumer loan delinquencies at historic lows since the beginning of the pandemic.

For state and local governments, the withdrawal of key federal support measures to households amid still high levels of unemployment will likely further dampen tax revenue and force them to increase spending on social safety net programs. The impact will be greatest in localities with higher shares of low-income households. State and local governments are already facing major budget shortfalls in the coming fiscal year because of a decline in revenue and higher spending on health, safety and social services.

Without federal relief, we expect state and local governments to address mounting budgetary pressure by cutting spending on certain services and laying off staff, which will weigh on the recovery in employment and economic activity. State and local government employment, which makes up 13% of total employment, was 6% below pre-pandemic levels as of July. The decline reflects layoffs in educational services at the state level and broad-based job losses at the local government level. State-level austerity will have also negative ripple effects on local governments and public-sector entities that rely on state funding.

Given the acute pressures on many households, businesses and governments, we expect Congress to pass a support package in the coming weeks, particularly since virus infections remain high in many states. The timing, however, is uncertain and there are several obstacles to an agreement. Key among them is that Republican and Democratic lawmakers remain far apart on many points, including the size of the fiscal relief package and funding for state and local governments. Moreover, although the House will return to session this week to provide emergency funding to the US Postal Service, the full Congress is not currently scheduled to return to Washington until after Labor Day.

The timing and size of the ultimate support package will factor into our outlook for the economy and credit conditions. In the absence of a significant improvement in the public health situation that would allow for a stronger rebound in economic activity, further delays in fiscal support could mean more relief will be needed to limit permanent damage to household and business balance sheets. The absence of a deal in the coming months would pose significant risks to the economic recovery.

The recent executive actions meant to provide relief to vulnerable households are subject to implementation risk and too limited in scope to provide significant support to the economy. For example, the executive orders extend supplemental UI benefits at a reduced rate of $400 weekly, with $300 coming from the federal Disaster Relief Fund and the remainder funded by the states. If implemented, this order will result in many unemployed continuing to receive more than they did when working. However, it is unclear whether states will be able to administer and finance the benefits. In addition, the $44 billion allocated from the Disaster Relief Fund would likely last only four to five weeks given current levels of UI benefit claims.

Other executive actions direct housing agencies to consider providing relief to households facing financial hardship, tax authorities to defer payroll taxes for workers making less than $100,000 a year, and the Department of Education to extend student debt relief provisions that were set to expire in September.

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Canada's strong institutional and governance framework mitigate its exposure to cyberattacks

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On 15 August, the Office of the Chief Information Officer of the Government of Canada (Aaa stable) announced recent credential-stuffing cyberattacks, in which hackers use usernames and passwords collected from hacking other platforms. The cyber events led the Canada Revenue Agency (CRA) to temporarily shut down online services delaying thousands of applications for COVID-19 emergency benefits such as the Canada Emergency Response Benefit and the Canada Emergency Student Benefit until services are restored, most likely on 19 August.

These credit-negative attacks raise cybersecurity risks for Canada. Like other sovereigns with robust institutional and governance frameworks that have highly developed cybersecurity strategies and defense capabilities, Canada is vulnerable to cyberattacks from sophisticated actors. However, its demonstrated resilience to external shocks and institutional capacity to respond effectively to a successful cyberattack largely mitigate the potential credit effects of these events. Canada's relatively large and diverse economy and sizable fiscal resources also buffers any potential economic effects.

Overall, we assess Canada's institutions and governance strength at "aaa," the highest possible score in our sovereign ratings methodology, reflecting its very strong government effectiveness and robust institutional framework.

The recent cyberattacks were launched on the GCKey Service Accounts used to access Government of Canada Services in approximately 30 federal departments and CRA accounts. Of the roughly 12 million active GCKey accounts in Canada, hackers accessed the credentials of over 9,000 users fraudulently and targeted approximately 5,600 CRA accounts, in which they were able to access banking information and submit fraudulent claims for government programs. Even strong systems are vulnerable to attacks because relatively weak usernames and passwords can lead to disruptions of entire portals with millions of users.

As we have noted in prior research, the most likely avenues through which a successful cyberattack could affect the credit profile of a highly rated sovereign such as Canada would be through heightened political risk or the exposure of an unknown weakness in its institutional framework.[1]

Larger government entities tend to have higher public profiles and control over highly sensitive or confidential information, which increases their likelihood to be targeted for attacks. For example, in recent years criminals have attempted to disrupt essential government services with attacks in Estonia (A1 stable), Ukraine (B3 stable) and Finland (Aa1 stable) and have tried to access sensitive information, such as the theft of US government employees' classified information. Cybersecurity attacks on central banks in Bangladesh (Ba3 stable) and Mexico (Baa1 negative) were financially motivated. In general, however, the government sector, which spans both sovereign and regional and local governments faces medium vulnerability to cyber risk and low impact from this risk.

Endnotes

1 Cyberattacks on governments are rising but pose limited risks to credit quality, 25 November 2019.

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Bermuda's easier visa conditions for remote workers is credit positive

Originally published on 19 August 2020

On 13 August, Bermuda's (A2 stable) Premier David Burt announced that a New York-based technology firm will take advantage of the "Work from Bermuda" visa program and relocate its senior staff to Bermuda in September. The program allows foreign professionals to work remotely from Bermuda for up to a year. It received more than 100 applications in the first two weeks after it was announced at the beginning of August.

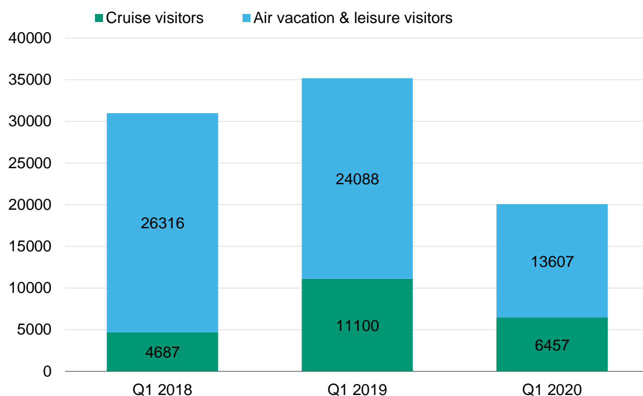
The arrival of professionals, whether independently and individually through this program or through corporate relocation programs is credit positive for Bermuda because tourism comprises around 18% of GDP and business visitor spending is an important source of revenue. The government estimates that the average business visitor spends $1,406 per person in an average stay of 5.7 days. If implemented successfully, we expect the program to drastically increase both per-person spending and the average length of stay.

If successful in attracting residents to Bermuda for a year, the programs will support domestic demand and growth, potentially increasing tourism activity both during and after the pandemic. The latest tourism data shows Bermuda's tourism sector cruise arrivals decreased 41.8% in first-quarter 2020 compared to the previous year, a steep deterioration. Similarly, air travel declined by 37.7% in the first quarter of 2020. We expect second-quarter 2020 tourism to decline even more, contributing to an economic contraction this year (see Exhibits 1 and 2). The program's successful implementation will increase domestic demand and help improve growth while supporting fiscal performance in 2020-21. Currently, we expect Bermuda's economy to contract by 6% in 2020 and run a primary deficit of 2.4%. In 2021, we expect GDP growth to recover to 1.2%.

Exhibit 1

Bermuda's tourism sector deteriorated sharply in the first quarter of 2020

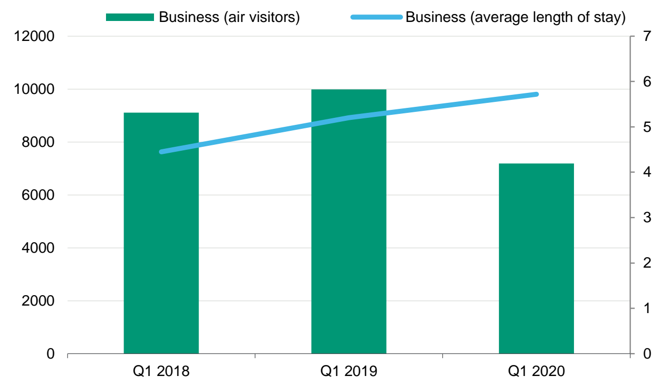
Number of visitors



Source: Bermuda Tourism Authority

Exhibit 2

... with business visitors declining



Source: Bermuda Tourism Authority

Additionally, on 17 August, the US Center for Disease Control and Prevention (CDC) recategorized Bermuda to "Level 2- Practice Enhanced Precautions" from its highest risk category of "Level 3 - Avoid Nonessential Travel." Bermuda's government repeatedly voiced its objection to the Level 3 category; it has had no confirmed local transmission of the coronavirus for approximately the past 60 days.

Bermuda's ability to quickly implement creative policies such the new visa program is credit positive and demonstrates its ability to endure shocks and be adaptable in a relatively short time frame.

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Normalisation of UAE-Israel ties supports UAE's tourism sector, improves Israel's security

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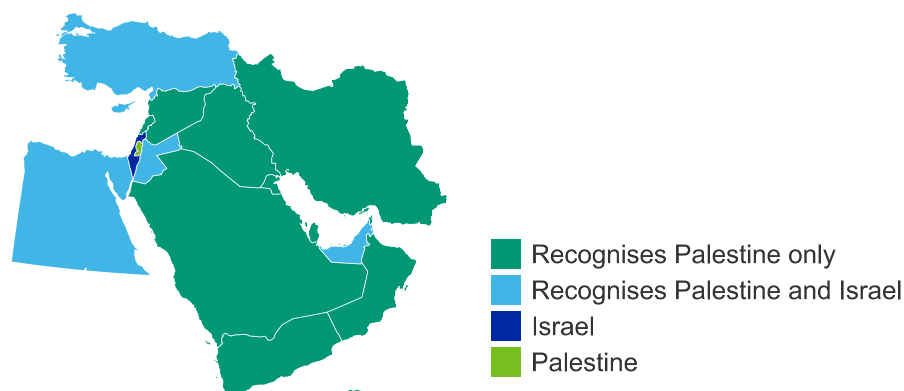
On 13 August, Israel (A1 stable) and the United Arab Emirates (UAE, Aa2 stable) announced that they would fully normalise diplomatic relations, marking the first time a Gulf sovereign has formally recognised Israel since its creation. This will have important economic and geopolitical ramifications for both sovereigns, with the UAE particularly benefiting from enhanced tourism and transportation opportunities, while the formalisation of ties will support Israel's improving security situation. However, for the UAE the deal will aggravate already high tensions with Iran, which remain the primary geopolitical risk for the emirates.

While ties between Israel and the GCC sovereigns have been improving informally for many years – for example, in the areas of defense, medical technology and financial partnerships as well as through increased cultural interactions such as sporting events – the formalisation of diplomatic ties with the UAE is a further step in Israel's improving diplomatic and economic relations with Arab countries.

The UAE is only the third Arab country to formally establish ties with Israel after Egypt (B2 stable) and Jordan (B1 stable), and may spur recognition from other GCC countries (see exhibit). For now, closer economic ties and co-ordination on defense and security issues will further the improvement in Israel's security situation recorded in recent years. Additionally, the agreement stipulates a pause in Israel's plans to extend its sovereignty to parts of the West Bank. The clause reduces the risk that tensions with Palestinians escalate, leading to a deterioration in relations with some of Israel's allies.

The UAE is the first GCC sovereign to recognise Israel



Source: Moody's Investors Service

Nonetheless, Israel will continue to face elevated political risks inherent in the Middle East that can affect the economy and public finances, including ongoing tensions with Iran, the potential to be embroiled in conflicts in the region, as well as the outstanding risk of an escalation of tensions with Palestinians.

For the UAE, the deal marks a significant foreign policy step that will expand its influence abroad, including with the United States (Aaa stable). Nonetheless, the normalisation of relations with Israel – and the benefits this will bring in terms of mutual investment, trade and tourism as well as cooperation on security and defence issues – is likely to come at the expense of a deterioration in diplomatic and potentially trade relations with Turkey (B1 negative) as well as an elevated risk of retaliatory attacks from Iran.

The deterioration in the UAE's relations with Turkey predates the UAE-Israel deal. Relations have been cooling since Turkey condemned the overthrow of Egyptian President Mohamed Morsi in 2013, and deteriorated more when Turkey affirmed its support for Qatar

(Aa3 stable) during the diplomatic crisis of 2017. The normalization of relations with Israel has further weakened the relationship, with Turkey threatening to withdraw its ambassador from the UAE. Regardless, any suspension of trade ties would have a minor direct credit implication as bilateral goods trade between the UAE and Turkey is limited: Turkey accounts for less than 2% of the UAE's total exports, and less than 2% of total imports, equivalent to around $7 billion in total bilateral trade.

However, the potential stirring of tensions with Iran is more credit relevant for the UAE. Tensions with Iran remain the primary driver of our geopolitical risk score for the UAE, and the UAE's economy (and Dubai's in particular) remains highly vulnerable to attacks from Iran, which could undermine its status as a safe haven for regional investment and prompt an exodus of expats.

Delegations from both countries will meet over the coming weeks to discuss agreements on travel, trade and the opening of diplomatic offices. While the details of the relationship have yet to be concluded, the deal could present significant opportunities for bilateral trade, tourism and investment between the two countries.

Although coronavirus effects will constrain near-term benefits for on air travel, the UAE's air transportation sector is well positioned to take advantage of a normalisation in relations. The UAE's two largest airlines, Emirates and Etihad, could attract Israeli passengers by leveraging their hub status and capitalising on Israeli airlines' inability to use the airspace over Saudi Arabia (A1 negative), although Israel is reportedly seeking approval for direct flights over Saudi Arabian airspace to UAE airports. In addition to passengers using the UAE as a hub for onward travel, there may also be some demand for direct tourism between the two countries, supporting passenger traffic volumes marked by slower growth in arrivals even before the pandemic.

Israel has also been successful in developing an innovative high-tech knowledge economy, which Abu Dhabi (Aa2 stable) is keen emulate as part of its Vision 2030 non-oil diversification plans. Over the medium term, the infusion of Israeli foreign investment, human capital and intellectual property could support the development of the knowledge economy in the UAE. Even prior to the deal, Israeli and Emirati companies in the defence and technology sectors collaborated on developing solutions to combat the coronavirus outbreak.

While Israel's economy is already more diversified, we expect it will also benefit from the improving ties, particularly in sectors in which it can export expertise to the UAE such as IT, desalination technology, architecture, further medical cooperation and advanced agriculture. According to Israel's Economy Ministry, the normalisation of ties could increase exports to the UAE to $300-$500 million annually (0.3%-0.4% of Israeli exports), and UAE investments in Israel could reach $350 million a year (1.9% of inbound foreign direct investment). Israel will also benefit from access to more secure oil supplies, although its energy security had already improved markedly following the Tamar and Leviathan gas field discoveries.

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» Roper Technologies' Vertafore acquisition is credit positive

» Southwestern Energy's acquisition of Montage Resources is credit positive for both companies

» Applied Material's results and outlook highlight strong business profile and financial strength

» Merger will be credit positive for Shandong Hi-speed, but effect on Qilu depends on stage of merger

» China Evergrande's sale of stake in property management arm is credit positive, but constrained by repurchase obligation

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» Empresas Publicas de Medellin's claims against Ituango contractors and board's resignation are credit negative

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» Russia extends regulatory forbearance measures, a credit negative for banks

» BLOM Bank's sale of Egyptian subsidiary would provide much-needed capital enhancement

» Saudi banks' first-half loan impairments offset increased revenue, decreasing profits 10% from year ago

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Editors

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