Credit Outlook

24 August 2020

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The coronavirus will spur customers, employees and governments to make new demands of corporations, which will curb revenue and profit potential long after the pandemic recedes.

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Sabre's $500 million equity issuance enhances liquidity amid depressed travel markets

Originally published on 19 August 2020

On 19 August, Sabre Holdings Corporation (Ba3 negative) announced that its parent holding company, Sabre Corporation, is raising $250 million of mandatory convertible preferred shares and $250 million of common shares. The injection of net cash proceeds from the new preferred shares, which we treat as equity, and common shares is credit positive. Sabre will gain meaningful additional liquidity and alleviates pressure on the company's credit profile from the sharp decline in global air travel, including travel restrictions and flight cancellations.

We expect Sabre to maintain at least adequate liquidity over the next 12 months notwithstanding the negative effect of COVID-19 and the global recession. Pro forma for the proposed issuances of preferred and common shares and adjusting for near-term cash outflows including potential refunds and severance payments, Sabre will have roughly $1.7 billion of balance sheet cash compared to $1.3 billion at the end of June 2020. Sabre has historically maintained a large share of cash at its overseas subsidiaries to support its large geographic footprint of operations, and management estimates roughly $150 million is needed globally.

The company suspended common dividends, which eliminates a $154 million cash outflow over the next 12 months with another $70 million preserved by suspending share buybacks. Sabre indicates that roughly two-thirds of its cost structure is variable, such as incentive expenses which are tied directly to revenues, and the company estimates that in a scenario with no net bookings, its monthly cash burn rate is roughly $80 million.

Sabre's Ba3 corporate family rating reflects our view that Sabre will be able to navigate current challenges despite pressure on revenue and profit margins from COVID-19 and global economic uncertainty. The new equity issuance show Sabre remains committed to disciplined financial policies and debt repayment when travel demand eventually rebounds as the impact of COVID-19 and the global recession abates.

Revenue for second-quarter 2020 declined by 92%. We expect Sabre's revenue to remain depressed for the remainder of 2020, reflecting mandated travel bans and flight cancellations, followed by quarterly revenues gradually recovering, but remaining below, 2019 levels through 2022. Consistent with our macro outlook, we assume flight schedules and travel demand will only partially recover entering 2021 given the time needed for airlines to restore capacity.

Sabre's credit profile is supported in the near term by significant cost reductions in response to revenue declines and by its ability manage growth investments and IT spend to preserve liquidity. A good portion of Sabre's costs are variable including incentives paid for reservations and employee compensation (all employees, including executives, took temporary pay cuts). Beyond the near term, Sabre benefits from its good operating scale, high proportion of transaction-based revenues, and market leadership as the second largest provider of Global Distribution System (GDS) services globally which better positions the company when air traffic and travel demand rebound from currently depressed levels. Sabre recently announced multi-year contract renewals with airline partners and has added new niche airlines to its revenue base. To the extent the negative impact of COVID-19 is more severe or extends beyond the third calendar quarter, there could be further degradation to Sabre's credit profile.

Based in Southlake, Texas, Sabre Holdings Corporation is a leading global travel platform organized in three segments: the Travel Network segment includes revenues from GDS services; the Airline Solutions segment includes a software-based passenger reservation system as well as commercial and operations offerings to the airline industry; and the Hospitality Solutions segment includes software revenues from Sabre's central reservation and property management system offerings.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.

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Analog Devices' third-quarter revenue declines

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On 19 August, semiconductor maker Analog Devices Inc. (Baa1 stable) reported a 1% year-over-year revenue decline to $1.46 billion for its fiscal third quarter, which ended 31 July (better than our expectations for a 4% decline) and forecast flat revenue year-over-year next quarter.

The results were credit negative. Still, Analog's outlook for flat revenue next quarter is better than those of its peers: Texas Instruments Inc. (A1 stable) forecast a 10% revenue decline and NXP Semiconductors N.V. forecast a 12% decline.

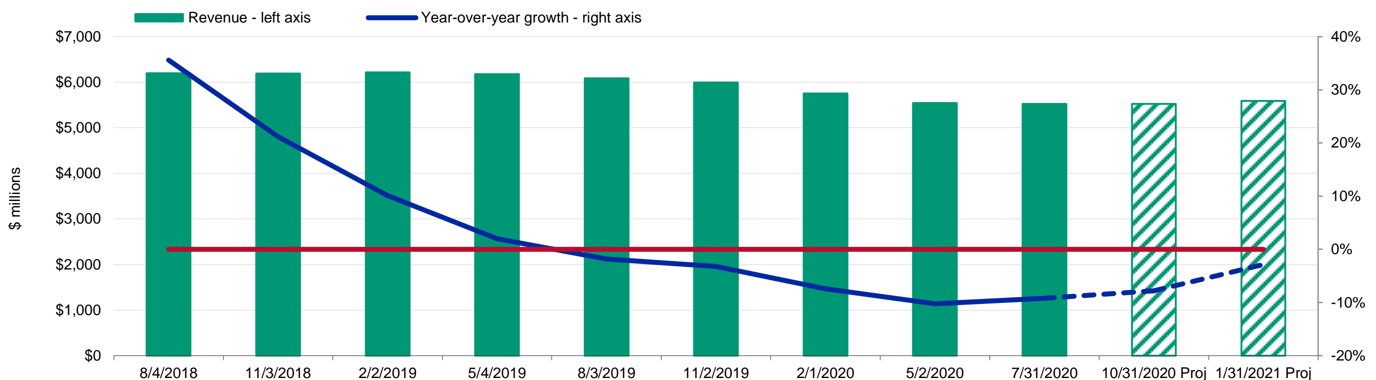
Analog cited strength in its industrial (especially medical) datacenter, and communications end markets (5G and wireline) that was offset by factory shutdown driven weakness in automotive (down 29% year-over-year) and soft consumer end markets. In the October quarter, Analog anticipates continued growth in its industrial end markets and a return to growth in automotive, which will be offset by a 20% decline in communications end markets as 5G deployments take a pause.

Following Analog's projected flat revenue for the October quarter we are assuming 5% growth in the quarter ending January 2021. On a trailing 12-month basis, we project Analog's trailing 12-month revenue will bottom in October at $5.52 billion, an approximate 8% year-over-year decline (see Exhibit 1), which compares to a 22% year-over-year decline in trailing 12-month revenue during the financial crisis in October 2009.

Exhibit 1

Analog's revenue is in a bottoming process

Trailing 12-month revenue and year-over-year growth

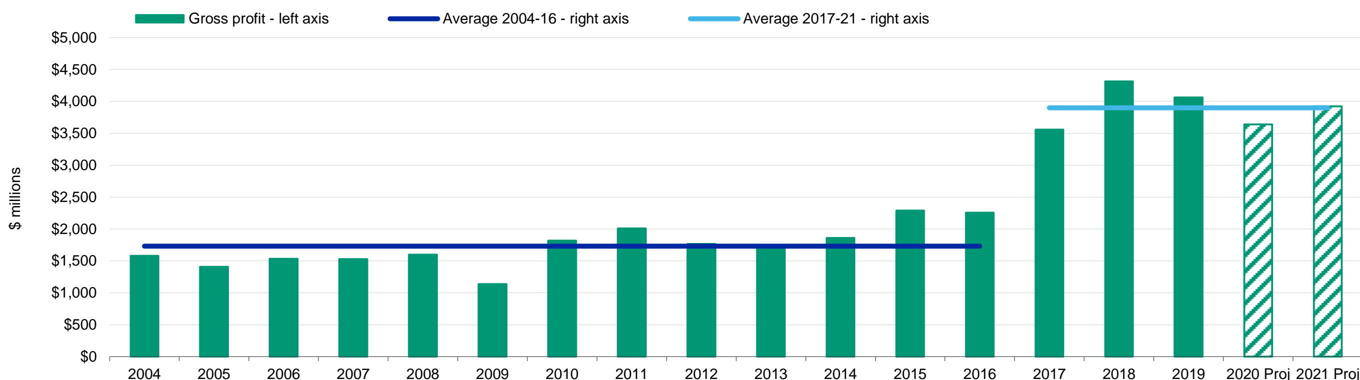


Sources: Analog, Moody's Financial Metrics and Moody's Investors Service projections

Despite this coronavirus-driven downturn and related earnings decline at Analog, we expect the company will still generate solid profitability, margins, and cash flow after capital spending. Even with a projected, volume-driven decline in 2020, gross margins on average are about 5% higher in recent years than the 2004-16 average and 9% higher in fiscal 2020 than in 2009 (see Exhibit 2).

Exhibit 2

Analog's gross profit is structurally higher

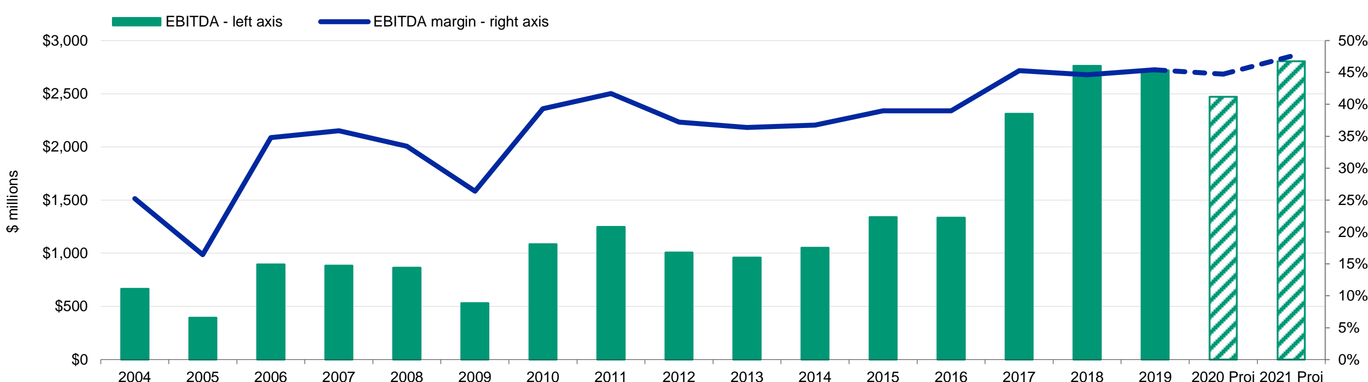


Sources: Analog, Moody's Financial Metrics and Moody's Investors Service projections

Combined with good cost controls but steady spending on research and development, we project Analog's quarterly EBITDA will average about $670 million the rest of 2020 ($70 million above our earlier expectations) while average EBITDA margins of 47% (see Exhibit 3) compare very favorably to 26% during the financial crisis in 2009.

Exhibit 3

Analog's EBITDA and EBITDA margin long-term uptrend will continue

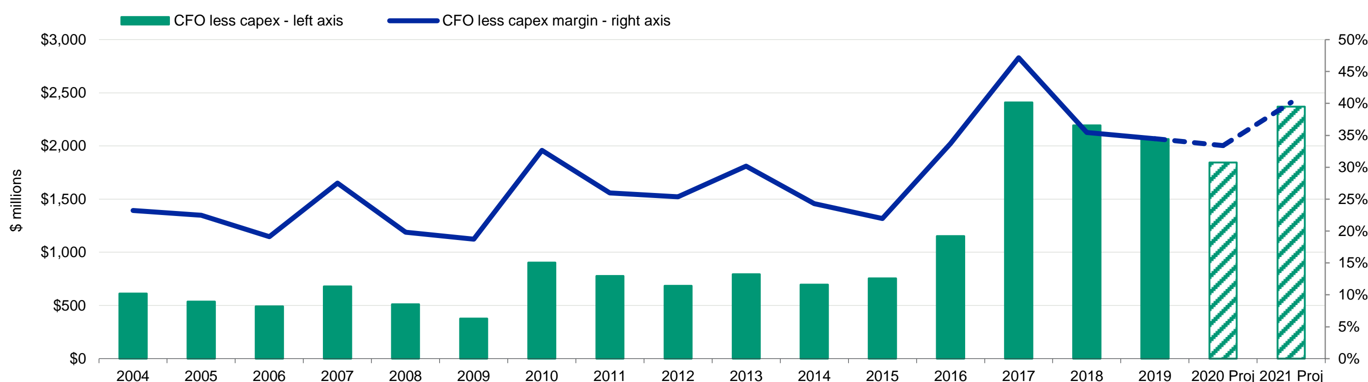


Sources: Analog, Moody's Financial Metrics and Moody's Investors Service projections

With Analog converting about 77% of its EBITDA into cash flow from operations less capital spending over the last seven years, we expect the company will generate approximately $1.8 billion cash flow after capital spending in fiscal 2020 (see Exhibit 4).

Exhibit 4

Analog's cash flow from operations less capital spending and margins will decline in 2020, but will remain strong



Sources: Analog, Moody's Financial Metrics and Moody's Investors Service projections

Analog will continue its commitment to a robust dividend return to shareholders, with a projected payout of approximately $880 million in 2020, which is about 2.75x what the company paid during the financial crisis in 2009. Despite the coronavirus-driven downturn, we project Analog will generate about $960 million in free cash flow (after dividends) in fiscal 2020. Analog has generated positive free cash flow in every quarter over the last decade.

Throughout 2020, Analog will maintain a very strong liquidity profile. Analog's next debt maturity is January 2021 when a $450 million note comes due. As of July 2020, Analog had cash and short-term investments of $1.09 billion. Given the modest capital intensity of the high performance analog sector, a track record of consistent free cash flow generation through various periods of economic stress over twenty years, Moody's views the company's liquidity profile as very strong. Analog also maintains an unused $1.25 billion unsecured revolving credit facility that matures in June 2024.

Under these conservative assumptions, we project leverage would improve modestly, with adjusted gross debt to EBITDA of about 2.6x at the end of fiscal 2020, up slightly from 2.4x one year prior. Similarly, the company's free cash flow to adjusted gross debt is projected at 15%, down from 19% in 2019.

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NVIDIA's key end-markets boost second-quarter revenue, a credit positive

Originally published on 20 August 2020

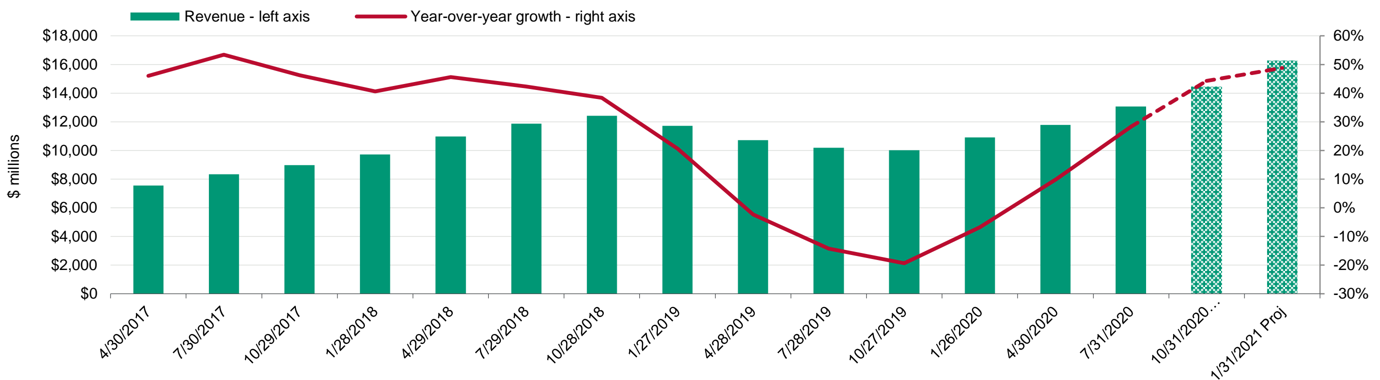
On 19 August, semiconductor maker NVIDIA Corporation (A3 positive) reported a 50% year-over-year increase (up 29% excluding the recently acquired Mellanox) in revenue to $3.9 billion for its fiscal second quarter, which ended 28 July. The company forecast $4.4 billion of revenue for a 46% year-over-year increase next quarter, or 29% excluding our estimate the of $600 million in revenue for Mellanox. NVIDIA's July quarter results and outlook remain driven by strength in key end markets of gaming and datacenter (combined 88% of revenue), with sequentially flat revenue in its other segments.

Following NVIDIA's projected 46% year-over-year increase in revenue for the October quarter, we project a 40% increase in revenue for the fourth quarter ending January 2021. NVIDIA's trailing 12-month revenue will then approximate $16.2 billion at January 2021, representing a 49% year-over-year increase (see Exhibit 1).

Exhibit 1

NVIDIA's revenue growth will continue over the next year

Trailing 12-month revenue and year-over-year growth



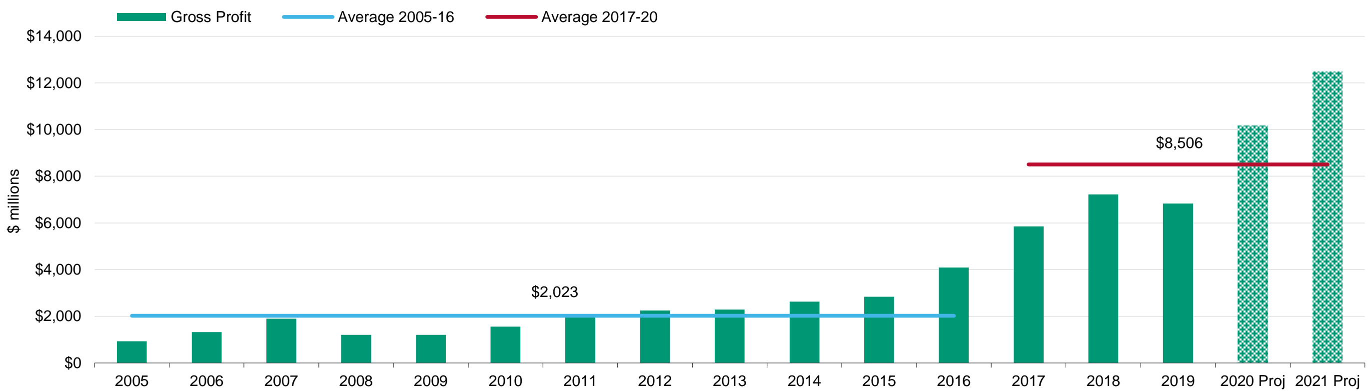
Sources: NVIDIA, Moody's Financial Metrics™ and Moody's Investors Service projections

Despite the coronavirus-driven macroeconomic weakness, we expect NVIDIA will generate strong profitability, margins, and cash flow after capital spending. NVIDIA's gross margins on average are about 14% higher in recent years than the average between 2005 and 2016, with gross profit dollars more than 3x higher (see Exhibit 2).

Exhibit 2

NVIDIA's gross profit is structurally higher

Calendar year-end



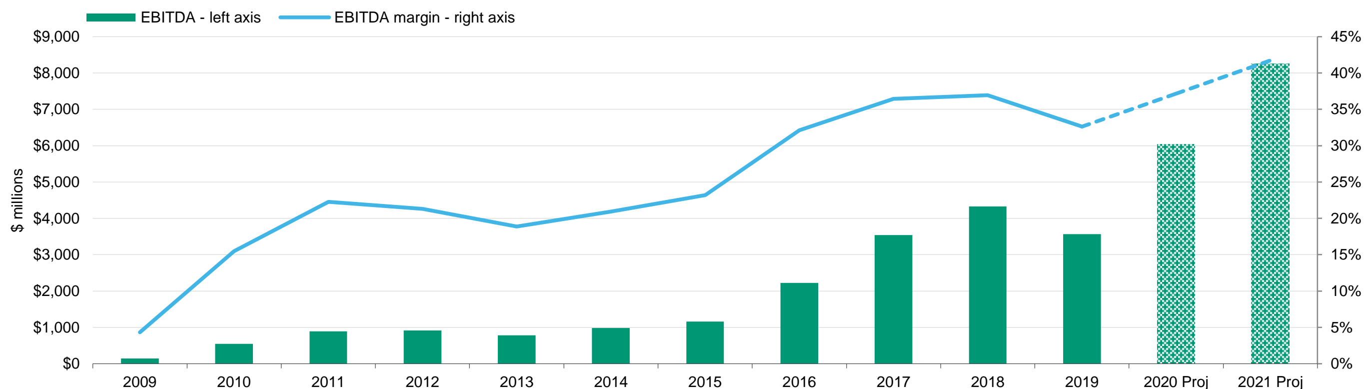
Sources: NVIDIA, Moody's Financial Metrics™ and Moody's Investors Service projections

Even with steady spending on research and development, we project NVIDIA's quarterly EBITDA will average $1.8 billion during the second half of fiscal January 2021 ($1.1 billion the year prior) while average EBITDA margins of 42% (see Exhibit 3) are up from 37% in the second half of 2019 and more than double the margins achieved during the financial crisis in 2009.

Exhibit 3

NVIDIA's EBITDA and EBITDA margin long-term uptrend will continue

Calendar year-end

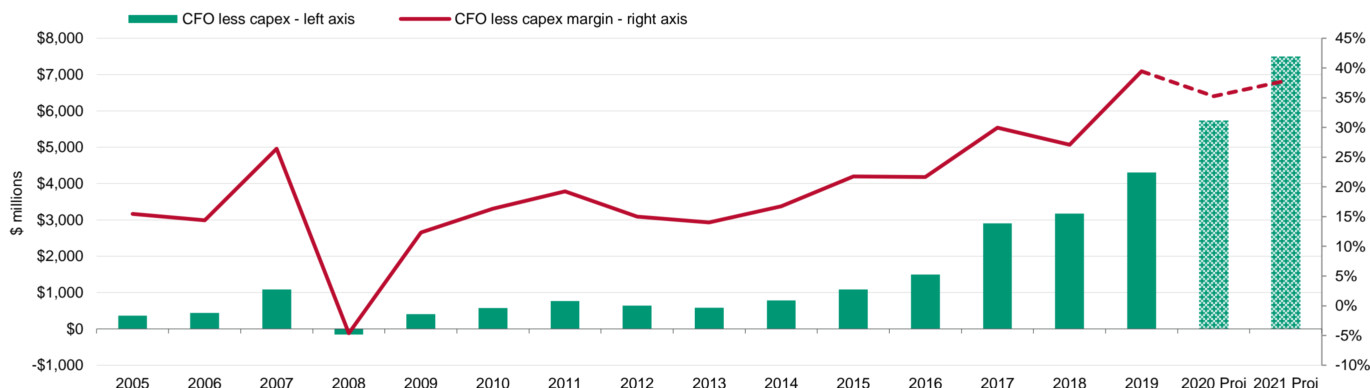


Sources: NVIDIA, Moody's Financial Metrics™ and Moody's Investors Service projections

With NVIDIA converting about 84% of its EBITDA into cash flow from operations less capital spending over the last decade, we expect the company will generate approximately $5.7 billion cash flow after capital spending in the fiscal year ending January 2021 (see Exhibit 4).

Exhibit 4

NVIDIA's cash flow from operations (CFO) less capital spending and margins will decline in 2020, but will remain strong
Calendar year-end



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

We project NVIDIA's dividend will approximate $390 million in fiscal 2021, just 7% of our projected cash flow after capital spending. Despite the coronavirus-driven economic downturn, we project NVIDIA will generate about $5.3 billion in free cash flow (after dividends) in fiscal 2021. Aside from 2008, NVIDIA has generated positive free cash flow in each of the last 15 years.

Throughout 2020, NVIDIA will maintain an excellent liquidity profile. NVIDIA has no debt maturities until $1 billion comes due in September 2021. As of 30 July, NVIDIA had cash and short-term investments of $11 billion, after having used $5.9 billion to fund the acquisition of Mellanox in April. Assuming a continuation of no share buybacks, we project cash will exceed $14 billion at year end. Given the low capital intensity of NVIDIA's business model, a track record of consistent free cash flow generation through various periods of economic stress over fifteen years, Moody's views the company's liquidity profile as excellent. NVIDIA also maintains an unused $575 million revolving credit facility that matures in 2021. Under these assumptions, we project leverage will remain very modest, with adjusted gross debt to EBITDA of about 1.3x and free cash flow to adjusted gross debt of 65% at the end of fiscal 2021.

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Wm Morrison's online services expansion is credit positive

Originally published on 19 August 2020

On 19 August, UK grocer Wm Morrison Supermarkets plc (Morrisons, Baa2 stable) announced that it is expanding its online deliveries by listing a wider range of products compared to the current offering[1] on the Amazon.com Inc. (A2 positive) UK grocery website and offering free same-day deliveries to Amazon Prime members.[2]

Morrisons will gain access to 15 million Amazon online customers and boost online sales at the same time that UK online grocery shopping has increased sharply in the months of lockdown and social distancing.

Online grocery sales are a modest 13% of total UK grocery sales, double this year. The online share will likely increase if the trend toward online shopping rather than traditional in-store shopping continues. And it has prompted a race for online market share.

Whilst the partnership between Morrisons and Amazon started in 2016[3] this deal further expands the cooperation between the two companies and could be a significant push into the UK grocery market for Amazon. The US company said in July that it intends to offer free grocery deliveries to its Prime customers in the UK, a move that Tesco Plc (Baa3 stable) followed earlier this month.

Although Amazon has struggled to make inroads into fresh groceries, it is likely to expand its physical grocery activities in the UK with plans to open 30 “Go” convenience stores. The move highlights the US e-tailer's commitment to the UK market and poses a major competitive threat to the sector. Its share of the UK grocery market is currently negligible and not even among the ten largest UK grocers, but it has signed up 15 million customers to its Fresh business, according to retail-week, a UK retail industry magazine and website.

Online sales are currently much less profitable for traditional brick and mortar grocers. The shift to online sales from physical sales benefits companies like Amazon. Among traditional brick and mortar grocers, Morrisons will benefit from leveraging off of Amazon's infrastructure and we would expect it to have higher margins than most competitors except Amazon itself.

All UK grocers have announced plans to increase their online delivery capabilities. Asda, the UK's third largest supermarket chain, which is owned by Walmart Inc. (Aa2 stable), targets increasing its online sales capacity 50% and reaching 1 million customers a week by year-end 2021 to regain market share. Although Asda same-store sales increased 3.8% in the quarter that ended 30 June, other UK grocers saw sales grow even faster.

Endnotes

1 “Morrisons on Amazon” already exists and has been available via an app for some months.

2 By the end of May, Morrisons intend to extend its online services nationwide to over 40 stores “covering the largest cities and most of these locations are already live today”. Morrisons also stated that Amazon's Prime Now customers “in over 90% of Greater London postcodes as well as customers in the other ten largest cities by population will be able to order their Morrisons on Prime Now and have their goods delivered by Amazon on the same day."

3 Morrisons also partners with **Ocado Group plc** (B2 stable), which powers the Morrisons.com webiste.

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IHS Towers' potential IPO in US is credit positive for Wendel

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On 18 August, France-based Wendel SE (Baa2 stable) announced that one of its investments, IHS Towers, is exploring a potential registered IPO in the US. A successful IPO would be credit positive for Wendel SE because it would increase the liquidity and transparency of Wendel's portfolio, adding a new listed asset to the portfolio of investments. It would also offer a potential exit path after seven years of ownership, and reduce the capital Wendel and other private co-investors would need to invest in the business to support its strong growth opportunities and aspirations.

Wendel's portfolio of assets was broadly evenly split between private and listed assets as of 30 June 2020, with private assets comprising approximately 52% of the value of Wendel's portfolio of investments (excluding cash). Wendel does not disclose the value of its private assets by companies but we would expect the share of listed assets to increase to well above 50% pro forma of the IPO of IHS Tower, which is one of Wendel's largest private investments.

A successful IPO would also offer Wendel a possible exit route from its stake in IHS Tower, the leading provider of telecom infrastructure in EMEA with strong market positions on the African continent and in the Middle East. Wendel has built a 19.2% stake in IHS Tower since its first investment in Africa and the telecom infrastructure sector in 2012. During its ownership period, Wendel has invested $830 million in IHS Towers. Although the IPO cannot necessarily be interpreted as a sign for an imminent exit of Wendel from its investment in IHS Towers, a public listing in the US certainly offers a very good exit path over time.

IHS Towers business has had strong growth since its inception in 2001 with the number of telecom towers it owns and rents out to telecom operators increasing steadily over the years to more than 27,000 towers in 2020. IHS Towers' capital expenditures averaged around 25% of revenue over the past three years with approximately 60% discretionary growth expenditures. In light of the growth dynamics of the telecom sector on the African continent and to a lesser extent in the Middle East, investment requirements will remain high for IHS Tower over the next few years. The IPO should give IHS Towers access to additional equity capital to fund its growth, thereby requiring less investments from its existing private shareholders.

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RWE's equity raise supports renewables growth, a credit positive

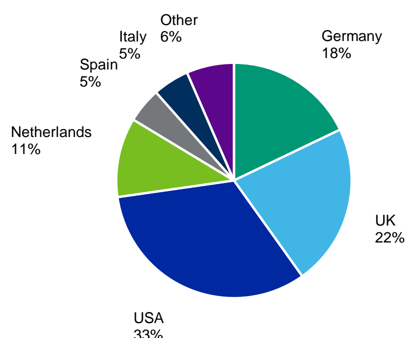
Originally published on 21 August 2020

On 18 August, RWE AG (Baa3 positive) raised new equity to increase its capital by 10%. The issuance, with gross proceeds of around €2 billion will allow RWE to accelerate its growth target in renewables, a credit positive. As of end-June 2020, RWE's installed renewables capacity was to 9.5 gigawatts (GW), with another 3.1 GW under construction.

The issuance will support RWE exceeding its renewables segment growth target of more than 13GW by 2022. We expect net investments over the next three years will be higher than the €5 billion previously communicated.

RWE will use part of the newly raised equity for its acquisition of Nordex's European wind and solar platform for around €400 million, which RWE announced on 31 July and expects to close in the fourth quarter of this year. On completion, RWE will add onshore wind and solar projects with a total capacity of 2.7 GW, bringing the company's total pipeline to nearly 25 GW. Most of Nordex's capacity is located in France and the acquisition will therefore diversify and strengthen RWE's geographical footprint (see exhibit).

The Nordex acquisition will increase geographic diversification of RWE's renewables
Installed capacity of renewables by country, as of end-June 2020 (Accounting view)



Total capacity of 9.5 GW.
Source: Company's reports and Moody's Investors Service

The decision to issue new equity to finance growth evidences balanced financial policies. RWE remains committed to deleverage its balance sheet and the company targets a net leverage (as per company definition) below or equal to 3x. Pro-forma for the equity issuance and the Nordex acquisition, the net leverage would have been 2.4x as of the end of the second quarter (using adj. Core EBITDA for the last 12 months), and we expect this figure to remain well below the 3.0x threshold at the end of 2020.

RWE's operating performance during the first half of 2020 was good, with the main effect from COVID-19 limited to lower demand and minor delays in a few renewable projects. Pro-forma earnings were supported by increased renewable capacity and higher wind yields compared to 2019, as well as UK capacity market payments and higher achieved margins for conventional generation. Net debt (as per company definition) increased to €8.0 billion, largely as a result of higher capital expenditures, variation margins and CO_2 provisions. RWE confirmed its full year guidance of an adjusted group EBITDA of €2.7-€3.0 billion for 2020.

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American Express' addition of Kabbage's technology is credit positive

On 17 August, American Express Company (Amex, A3 negative) announced that it will acquire substantially all of the financial technology firm (fintech) Kabbage Inc., a small business lender with proprietary and leading-edge technology. The modest acquisition gives Amex a bigger presence in the small business lending market and accelerates its ongoing efforts to further entrench its existing small business client base with additional services, a credit positive.

Amex is purchasing at an undisclosed price Kabbage's technology, data platform and intellectual property and not Kabbage's existing loan portfolio. Kabbage, a standalone online lender, halted all lending in March, which we believe was a result of coronavirus-related economic fallout. We believe this was a forced sale, which demonstrates the inherent weaknesses and challenges of smaller fintechs competing with much larger incumbent financial institutions.

We believe that Amex is acquiring Kabbage to expand the services it offers to its existing small business customer base. Amex is the largest small business card issuer in the US. Over the past several years, the company has also begun providing working capital loans to its small business customer base.

Kabbage's underwriting and data-gathering engine analyzes small businesses' cash flow based on bank account, payment and shipping data and accounting information to make real-time credit decisions. In addition to lending, Kabbage provides its small business clients a suite of tools to digitally manage their payments and cash flow, and recently introduced an integrated business checking account. Kabbage's senior leadership team will be joining Amex.

Although we believe the acquisition will likely take several years before it has more than a very modest effect on Amex's profitability, expanding its product offerings is particularly timely given the pandemic's disproportionately negative effect on the company. The decline in Amex's capitalization will be modest, but the acquisition brings typical integration risks, particularly those of a small entrepreneurial firm and a large, established incumbent.

The Kabbage acquisition is Amex's most recent in a string of small fintech acquisitions that accelerate its digital capabilities. Most of the recent acquisitions have focused on lifestyle services such as its 2017 acquisition of Cake Technologies, a UK-based firm whose app connects customers with restaurants and bars and its 2018 acquisition of Mezi, an artificial-intelligence-based virtual travel assistant. In 2019, Amex acquired Pocket Concierge, a Japanese-based restaurant reservation platform; LoungeBuddy, an app for booking airport lounges; and Resy, another restaurant reservation app. While these offerings appeal to many small business owners, the Kabbage acquisition, along with its acquisition late last year of acompay, a business-to-business supplier payments company, are important given that around 40% of Amex's proprietary network transaction volume comes from its small business cards and corporate cards to small businesses.

Fintechs often possess cutting-edge technology and innovative business models, but most, such as Kabbage, lack the scale and financial resources to compete with much larger incumbent financial institutions. In addition, online lenders, which rely on confidence-sensitive funding, are particularly susceptible to economic downturns such as the present one that drove Kabbage to put itself up for sale. Fintechs contrast with Big Tech firms such as Alphabet Inc. (Aa2 stable), Apple Inc. (Aa1 stable), and Facebook, Inc., which focus on growing their core businesses and are very wary of additional regulatory scrutiny. However, they have the potential to be formidable competitors in retail financial services given their large user bases, delivery of seamless user experience, long-term focus and significant capital resources.

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Banrisul's voluntary redundancy plan would be credit positive

Originally published on 18 August 2020

On 17 August, Banco do Estado Do Rio Grande do Sul S.A. (Banrisul, Ba3 stable, ba3[1]) announced that it is beginning negotiations with unions to set up a voluntary redundancy plan. Such a plan would reduce personnel costs, increase Banrisul's efficiency and improve its net income, all credit positives.

The coronavirus pandemic is challenging Banrisul's profitability amid low business volumes, rising provisioning costs and high administrative costs. In the first half of 2020, the bank's net income fell by 42%, driven primarily by a 5% decline in margins and a 34% rise in provisioning costs as its high administrative cost base rose.

Banrisul's profitability traditionally lags Brazil's largest banks. Its 2016-19 ratio of net income to tangible assets averaged 1.3%, below the 1.5% average for Brazil's leading private banks and the 1.4% system average.

As a public bank majority-owned by the Brazilian state of Rio Grande do Sul, Banrisul has limited capacity to cut administrative costs, particularly its personnel expenses. The bank's cost/income ratio averaged 61% during 2016-19, versus a system average of 53% over the same period, in large part because of its rigid labor costs. A new redundancy scheme would aid the bank in offsetting these structural cost. Additionally, Improved profitability would buttress Banrisul's capital generation.

The bank will continue to face a challenging 2020, given that we expect that low loan growth and asset risk will raise credit costs, and therefore reduce net income. The bank's 90-day problem loan ratio rose to 3.6% in June 2020 from 2.2% a year earlier and from 3.4% in March 2020. In response to the pandemic, the bank has renegotiated approximately 14% of its loan book, which has the potential to increase asset risk in the remainder of 2020 if the renegotiated loans stop performing.

Banrisul has yet to divulge details of the redundancy scheme. However, in 2017, the bank announced a voluntary early retirement offer for up to 700 workers, or more than 6% of its work force and a voluntary redundancy plan in 2018 for 600 workers, 5.6% of its workforce. Together, these led to savings of BRL220 million on a Moody's-calculated ongoing basis. Should Banrisul's latest redundancy program be as expansive as in 2017, we estimate that annual savings would be up to BRL104.5 million, equal to 9.8% of trailing 12-month net income to June 2020 (see exhibit).

Banrisul could save nearly 10% of net income if 700 workers agree to leave
Sensitivity analysis of possible redundancy plan savings

Number of workers made redundant	300	400	500	600	700	800
% of work force	2.9%	3.9%	4.9%	5.9%	6.9%	7.8%
Annual post tax savings (BRL millions)	44.8	59.7	74.6	89.5	104.5	119.4
% of net income	4.2%	5.6%	7.0%	8.4%	9.8%	11.2%

Sources: Banrisul and Moody`s investors Service

We expect that the bank's new redundancy program will give preference to those who have worked at the bank longest, and thus have accrued the most salary increases and benefits during their tenures. As such, any severance payments offered as part of the package will be more than offset by the ongoing salary savings.

Endnotes

1 The ratings shown in this report are Banrisul's local currency deposit rating and baseline credit assessment.

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Denmark's proposed special corporate tax is credit negative for banks

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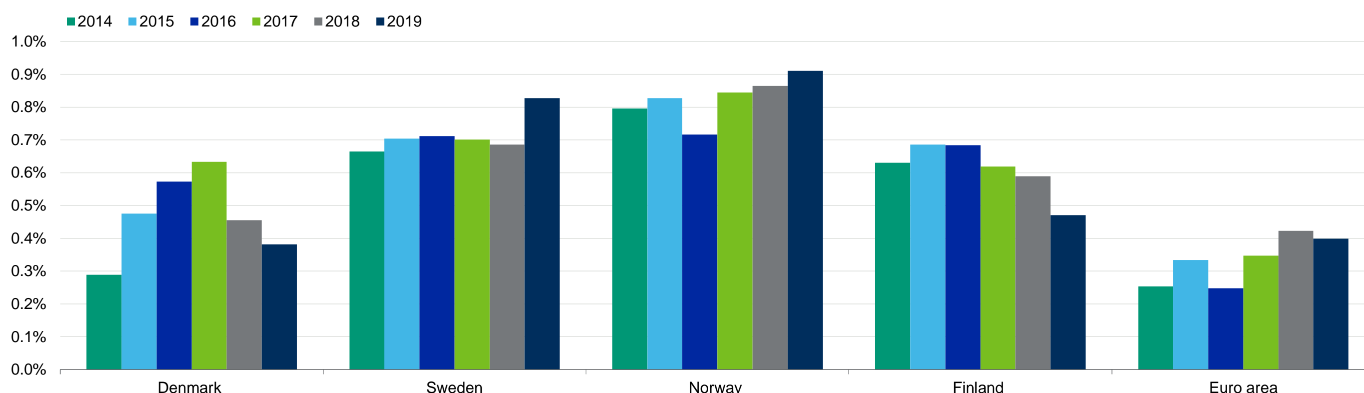
On 18 August, the government of Denmark (Aaa stable) announced a plan for additional taxes to help fund early retirement for certain categories of workers. By the end of a phase-in period lasting until 2025, the plan would be funded from additional levies on the private sector worth around DKK3.1 billion (approximately €415 million), of which DKK1.5 billion would be in the form of a special corporate tax on financial sector profits starting from 2023. The proposal requires the approval of the country's parliament.

The additional tax on profits would be credit negative for Danish banks because it would challenge their already-declining profitability. Danish banks' profitability has been falling in recent years because of a prolonged period of very low and negative interest rates, higher compliance costs and increasing funding costs as institutions issue more expensive non-preferred senior debt to comply with regulatory requirements.

Danish banks' profitability has been lower than their Nordic peers', and in 2019 it aligned with the lower profits of euro area banks (see exhibit).[1] Banks' profitability has been additionally hurt this year by the coronavirus-induced economic disruption.

Danish banks' profitability has been declining and was lower than Nordic peers
Net income/tangible assets for rated banks



Source: Moody's Investors Service

It is unclear how the proposed tax will be distributed among financial sector participants, which include pension funds and insurance companies, but the banking sector is at risk of contributing a significant portion of the DKK1.5 billion the government seeks. This amount would be equal to roughly 4% of Danish banks' and mortgage lenders' 2019 pretax profits.

Banks will try to pass on the extra cost to their customers through higher lending rates or fees, but its likely that the banks themselves will bear part of the cost. Lower profitability limits banks' internal capital generation and capacity to deal with shocks, reduces their attractiveness to investors and risks restricting their ability to lend and to profitably grow their business in the future.

If approved, the proposed corporate tax could take effect once the economy and banks have emerged from the coronavirus-induced disruption. The pandemic has prompted banks to increase their loan-loss provisions substantially so far this year from recent low levels ahead of an expected increase in problem loans. A deeper and more prolonged economic slowdown would have a correspondingly greater adverse effect on Danish banks' loan portfolios. Additionally, we expect less demand for credit and lower fee income for banks because of a stalled business cycle, and further margin pressure from an even longer period of very low interest rates.

Danish banks have been gradually expanding negative interest rates to a wider pool of depositors in a bid to mitigate pressure on net interest income and to allow them to better endure the prolonged period of lower-for-longer interest rates, which challenges their business models and profitability. Starting on 1 May, a number of systemically important banks began charging a negative 0.60% on private customers' deposits exceeding DKK250,000 (€33,500). We expect banks to continue to gradually lower the threshold for negative deposit rates.

Endnotes

1 The sector's weaker profit performance also reflects remediation costs at one of the two largest lenders in Denmark, related to potential money laundering.

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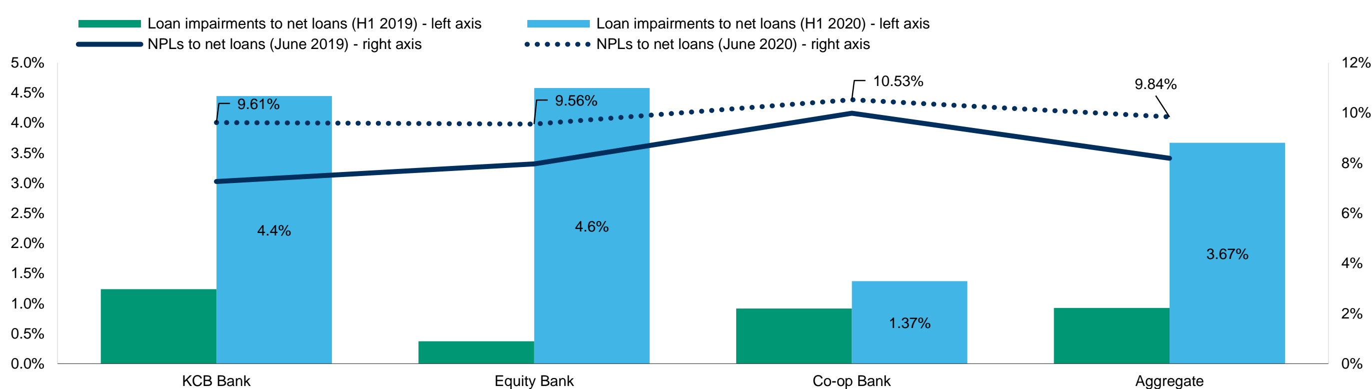
Kenyan banks' higher loan impairments erode first-half profits

As of 18 August, KCB Bank Kenya Limited (B2 negative, b2[1]), Equity Bank (Kenya) Limited (B2 negative, b2) and Co-operative Bank of Kenya Limited (B2 negative, b2) reported aggregate first-half 2020 profit of KES21.4 billion, down 26% from first-half 2019. The decline reflects a fourfold increase in aggregate loan impairments, offsetting an 8% increase in pre-provision income, a credit negative for the banks.

Aggregate loan impairments increased to around 3.7% of net loans during the first half, from 0.9% in first-half 2019. Aggregate nonperforming loans (NPLs)[2] increased to 9.8% of net loans as of 30 June, from 8.2% last year. Loan impairments for KCB Bank, Kenya's largest bank, were 4.4% of net loans, while loan impairments for Equity Bank, the third-largest bank, were 4.6% (see Exhibit 1). Both also reported larger increases in NPLs relative to Co-op Bank, Kenya's fourth-largest bank, although Co-op Bank's NPLs are the weakest as of June 2020. Equity Bank now has a high regulatory coverage ratio, with loan loss reserves to NPLs of 81% as of June 2020, compared to 75% for KCB Group, and 66% for Co-op Bank.

Exhibit 1

Kenyan banks impairments and NPLs increased over the past 12 months



Sources: Banks' financial statements and Moody's Investors Service

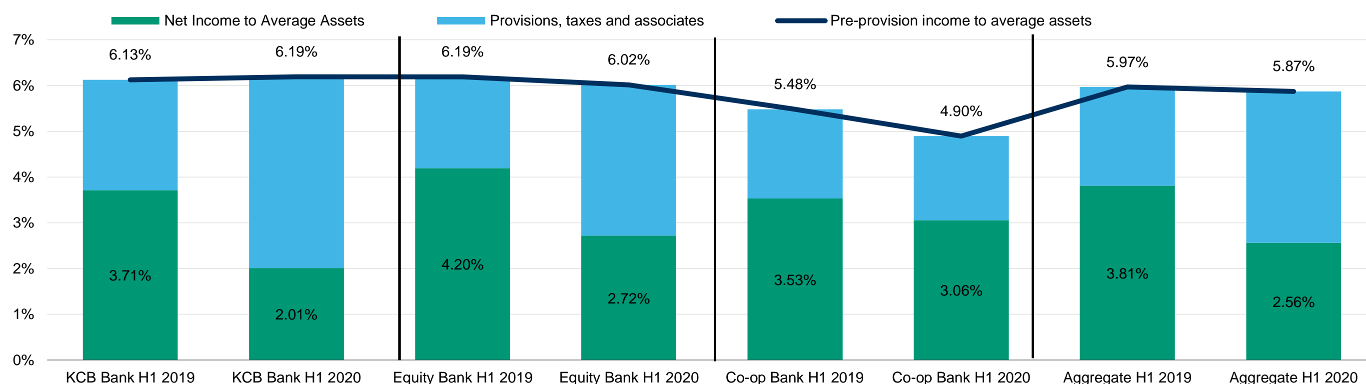
Coronavirus-related policy measures to promote loan restructurings mitigate borrower stress this year. Nevertheless, the banks' loan impairments anticipate accelerating NPL formation in 2021, especially among micro, small and midsize enterprises (MSMEs) and in stressed sectors such as tourism, hospitality and real estate. The magnitude of the impairments points to a potential systemwide deterioration in NPLs.

Over the next 12-18 months, we expect banks to continue to have a high percentage of impairments. KCB Group restructured 17% of its loans as of 30 June because of the coronavirus pandemic, while Co-op Bank restructured 14%. Equity Holdings did not provide restructured loan data, but identified 45% of loans that may require accommodation because of pandemic effects. Equity Holdings' exposure to MSMEs is the highest at 63%, compared with 7% for Co-op Bank and around 4% for KCB Group.[3]

Aggregate net income fell to 2.6% of average assets in the first half of 2020 from 3.8% a year earlier, but remains solid. Despite lower bottom-line profitability, the first-half results show the strength of Kenyan banks' recurring pre-provision earnings with aggregate pre-provision income a strong 5.9% of average assets in the first half, compared with 6.0% a year earlier. The 8% increase in first-half pre-provision income reflects an 11% increase in net interest income as continued balance sheet growth offset a 1% drop in noninterest income partly because of the Central Bank of Kenya's waiver on mobile transaction fees.

Co-op Bank's net income fell the least because of lower loan impairments. Equity Bank's and KCB Bank's pre-provision income was resilient and strong with an 11% in the first half of 2020, but higher loan impairments led to lower net income at 2.7% of average assets for Equity Bank and 2.0% for KCB Bank (see Exhibit 2).

Exhibit 2
Kenyan banks' profitability fell by varying degrees in the first half of 2020



Sources: Banks' financial statements and Moody's Investors Service

We expect all three banks to maintain strong capital and liquidity buffers which will support financial stability over the next 12-18 months. The aggregate ratio of shareholder's equity to assets was strong at 14.4%, versus 15.7% as of June 2019, and aggregate liquid assets to total assets ratio was 36.7%, versus 34.0% as of June 2019.

Endnotes

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

2 Problem loans exclude interest in suspense.

3 For Equity Bank and KCB Bank, we used the breakdown of their holding company as a proxy.

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Mali's military coup undermines already-weak institutions

On 18 August, a coup d'état in Mali (B3 stable) forced President Ibrahim Boubacar Keita, Prime Minister Boubou Cissé and a number of key officials to resign and dissolve the parliament and government, following their arrest.

The coup is credit negative for Mali because it weakens its fragile institutions and ushers in a period of uncertainty while the country is engaged in a protracted fight against violent extremism in the Sahel region. It also raises contagion risks for neighbouring countries where the coronavirus pandemic is exacerbating resentment over high and rising inequality.

There is a material risk that weaker institutions for Mali will hamper efforts to combat terrorism and organised crime in the Sahel region. The United Nations (UN), US and France have asked for the release of those arrested and a return to constitutional order, and political pressure on Mali is likely to mount. At the regional level, the Economic Community of West African States (ECOWAS) condemned the coup and closed all borders with Mali. It also suspended Mali from all regional bodies until those arrested are released and there is a return to constitutional order.

Reduced international trade and investment, if protracted as a result of the coup, will have a significant negative economic effect on Mali's economy. Although the country's mining sector, which provides around 25%-30% of government revenue and accounts for most of Mali's foreign earnings, can likely continue to operate for a few months, a more prolonged interruption to commercial and financial flows would hamper production.

The military coup echoes the 2012 coup that ousted former president Amadou Toumani Touré, which also began at the Kati military base outside Mali's capital of Bamako. The previous coup catalysed an armed insurrection in the north in 2012, and there are significant risks that the current coup will bolster militancy in the region.

The international community has been combatting extremists in the Sahel region since 2012, with the support of 5,000 French troops and 14,000 UN peacekeeping forces. The conflict began as ethnic clashes between marginalised Tuareg groups in the north seeking greater autonomy and support. It has evolved into a more entrenched armed conflict against violent extremism and terrorists from outside Mali, and spread throughout the Sahel region, destabilising Burkina Faso and Niger (B3 stable).

The National Committee for the Salvation of the People (NCSP), headed by army colonel Assimi Goita, intends to assume all executive powers during the transition. The NCSP indicated that it will return the country to civilian rule, though at an undetermined time. In the interim, it has pledged to respect all existing political agreements and continue to work with the international community, particularly France (Aa2 stable), and UN forces to combat violent extremism. The NSCP also confirmed its commitment to the 2015 Algiers Peace Accord with ethnic Tuaregs in the north of the country. The committee expects popular support following months of mass protests against the deposed government.

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UK exam assessment change will increase demand for universities, a credit positive

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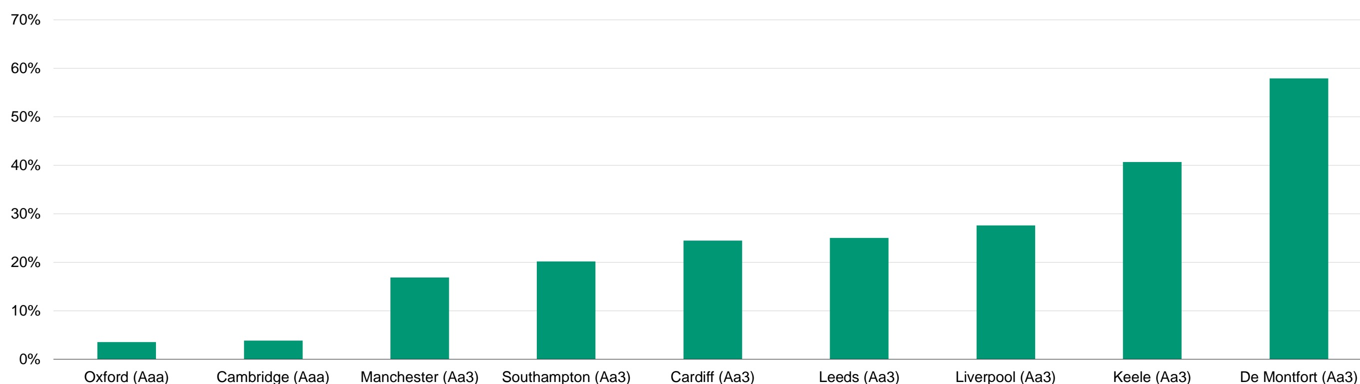
On 17 August, the UK (Aa2 negative) government announced that it would alter its method of assessing this year's exam results in England for university qualifications. The change will raise university-bound students' grades, leading to more students qualifying for in-demand universities (which includes rated universities), and higher enrolment for the next academic year starting in autumn 2020. While the last-minute change presents administrative challenges for universities, potentially raising costs, higher enrolment will boost tuition fee income, a credit positive for universities.

With the sudden change in the government's exam results policy raising demand significantly, the government has also abandoned its policy announced in May 2020 of a temporary student number cap for the 2020-21 academic year (set at 5% above pre-outbreak forecasts) in response to the coronavirus pandemic. The cap's removal will enable stronger universities to recruit more domestic students and offset potentially fewer international students. This reversal will also fuel competition and drive credit divergence in the sector, and universities with stronger market positions, which includes rated universities (see Exhibit 1), will be best positioned to raise enrolments and tuition fee income. Weaker universities will lose students whose higher grades will qualify them for places at stronger institutions. Although we expect rated universities to benefit from these changes, social-distancing capacity constraints limit their ability to recruit significantly more undergraduate students than planned, especially at very short notice.

Exhibit 1

Rated universities have varied exposure to domestic undergraduate fee income

Domestic undergraduate fee income as a percentage of total revenue, %, fiscal 2019

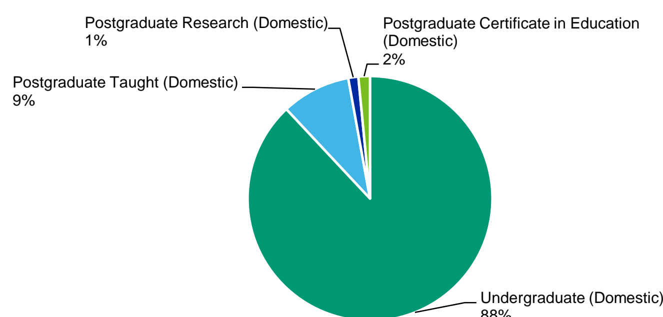


Sources: Universities' financial statements and Moody's Investors Service

The coronavirus pandemic has caused high uncertainty around student demand and enrolment for the next academic year.[1] However, domestic undergraduate demand has remained resilient, with acceptances 1% higher for 2020 entry versus 2019 entry.[2] Nevertheless, there is still significant uncertainty around international student enrolment, which accounts for 14% of total income for UK universities (fiscal 2019). (See Exhibit 2.)

Exhibit 2

Undergraduate tuition fees account for the majority of domestic tuition fee income for UK universities
Breakdown of domestic tuition fee income as percentage of total, fiscal 2019



Source: Higher Education Statistics Agency

Students were unable to sit exams this year due to the pandemic. In the absence of traditional exam results, the government tasked the Office of Qualifications and Examinations Regulation (Ofqual) with devising a method for assessing A level results for English students (which qualify them for university). The method resulted in lower-than-expected grades for many students. In particular, it appeared that under the algorithm-based method, students from disadvantaged backgrounds were disproportionately negatively impacted – this runs counter to the government's agenda of increasing higher education participation in underrepresented groups. Facing widespread protests at the outcome, the government reversed its decision and announced that final grades would be the initial, generally higher, teacher-set grades.

The government has implemented numerous support measures to assist universities facing financial difficulties due to coronavirus pressures.[3] For example, the government's restructuring regime announced in July 2020 confirms government support for struggling universities, although it does not guarantee that no university will fail. Weaker institutions which become financially unviable due to insufficient student demand (as a result of the coronavirus and related measures) are likely to benefit from government support through the restructuring regime.

Endnotes

1 See Coronavirus may cause operating deficits in 2021; strong balance sheets boost resilience, 18 May 2020.

2 See Rise in undergraduate acceptances for 2020/21 despite coronavirus demonstrates resilience of UK universities, 1 July 2020.

3 See Restructuring regime confirms government support in case of financial distress from coronavirus, a credit positive, 23 July 2020.

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CREDIT IN DEPTH

Corporations will assume the burden of safety, raising costs and lowering capacity

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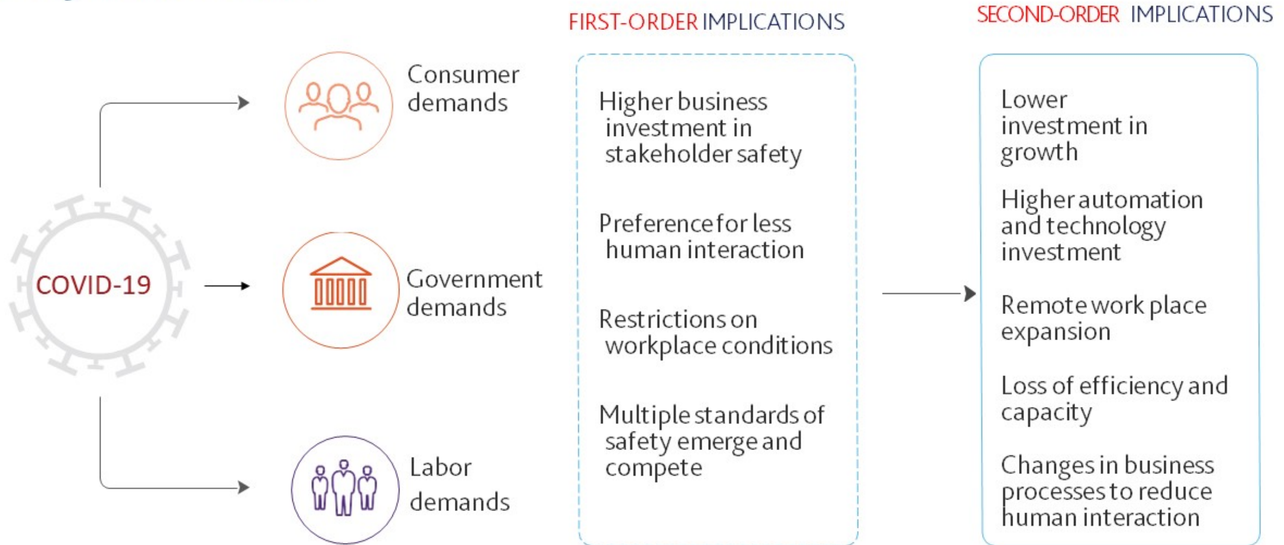
The coronavirus pandemic will profoundly affect the way corporates interact with employees, customers, governments and one another. Employees will seek a virus-safe workplace. Customers will prefer more digital products and services. Governments will seek greater engagement with management. All of these demands will require corporations to invest in a wide range of safety measures and protocols, which will raise their costs and lower their capacity, curbing revenue and profit potential long after the pandemic recedes.

- **Corporations will assume the burden of keeping employees, customers and society at large safe from infection.** Like the fear of terrorism 20 years ago, fear of contagion post-COVID will drive changes in how corporations function as customers, employees and regulators demand new safety protocols. But fear of contagion will affect a much wider range of corporate sectors, and some will be affected more than others.
- **Restaurants, lodging/leisure, tourism and airline companies will be transformed**. Companies are investing large sums in new technologies and capabilities to ensure customer and employee safety. They are implementing safety-oriented procedures to forestall regulations, but could find that the political pressure to "get tough" on safety leaves them subject to burdensome or conflicting rules.
- **Retail's structural shift will accelerate**. The pandemic has created hordes of online shopping converts who will be motivated by safety concerns to maintain their new habits. Investments required to change their sales approach, supply chains and operating strategies will weigh on retailers' capital plans and profits. An Increase in online shopping will lower retail property values, hurting retail landlords, but creating opportunities for telecom, tech and services companies.
- **Supply-chain dependent businesses will experience pronounced changes.** A move to regional supply chains, already occurring in autos and electronics, will accelerate. There will be further shifts toward more local production of critical goods like drugs. Lower global growth and changes in consumer preferences will weigh on the oil and gas markets globally, with lower demand for energy.
- **Emphasis on safety will shift ESG focus to social from environmental risk.** Corporations will likely forego energy savings in favor of ensuring better ventilation for employee and customer safety. Governments will play a larger role in private enterprise, while income inequality and information security issues will take center stage.

Corporations will assume the burden of keeping people safe from infection



Source: Moody's Investors Service

Click here for the full report.

Podcasts and Videos

Inside Emerging Markets - Podcast: Global remittances fall; sukuk issuance to rebound after first-half stumble, 19 August 2020

Christian de Guzman of the Sovereign team discusses how lower wages and the fall in employment of migrant workers in advanced economies will result in a decline in remittances to some developing economies. Also, Banking team analyst Nitish Bhojnagarwala talks about our outlook for the issuance of Islamic sukuk bonds.

Related reports: *Sovereigns – Global: Lower remittances after coronavirus to hurt consumption, raise external risks in major recipient countries* and *Cross-Sector - Islamic Finance: Sukuk issuance set for modest decline despite coronavirus outbreak*

Podcast: Nuclear plant operators face growing climate risk, 19 August 2020

David Kamran and Jairo Chung of the Infrastructure and Project Finance team discuss how worsening climate hazards will affect nuclear power plants.

Related report: *Electric Utilities and Power Companies - US: Nuclear operators face growing climate risk but resiliency investments mitigate impact*

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

» Equity issuance is credit positive for Rumo, neutral for Cosan

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

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

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

Banks

» BNDES’ first-half loan disbursements increased, a credit positive

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

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

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

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Editors

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