Credit Outlook

31 August 2020

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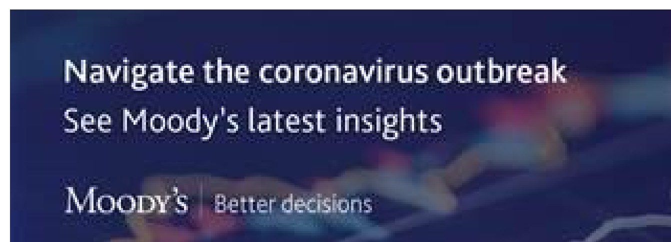

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Autodesk's growth moderates, but outlook is solid and credit profile remains strong

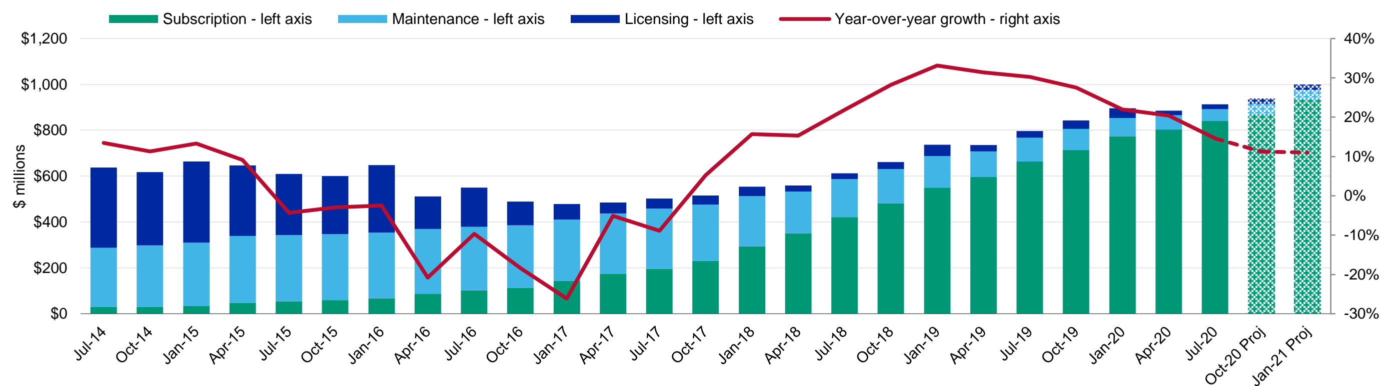
Originally published on 26 August 2020

On 25 August, Autodesk Inc. (Baa2 stable) reported a credit-positive 14.6 % year-over-year increase in revenue to a record $913 million for its fiscal second quarter that ended in July and forecast revenue growth of 11.2% next quarter. A leading provider of computer-aided design (CAD) software for the design, construction and management of buildings and civil infrastructure (roads, bridges, etc.) and manufactured goods and related equipment, Autodesk cited strength throughout its portfolio and across geographies, with notable strength in its architectural, engineering, and construction segment, which grew 19%.

While management noted a slowdown in mid-March alongside the onset of shelter-in-place orders, product usage in China, Korea and Japan has rebounded above pre-COVID-19 levels, with recovery in Europe and the US. Similar to last quarter, product subscription renewal rates improved on a sequential basis, which is a strong endorsement of the strategic nature of the company's products and stickiness of its customer base.

Following Autodesk's projected 11.2% revenue growth for the October quarter, we project 10% growth in the fourth quarter that ends in January 2021. Despite the coronavirus-driven economic downturn, Autodesk will generate revenue of about $3.7 billion, representing a 14% year-over-year increase (see Exhibit 1). This revenue growth compares to a 26% year-over-year decline in fiscal January 2010 during the financial crisis, when the company had a perpetual license business model as compared to the current ratable revenue recognition, subscription-based model.

Exhibit 1
Revenue continues long term uptrend under subscription model



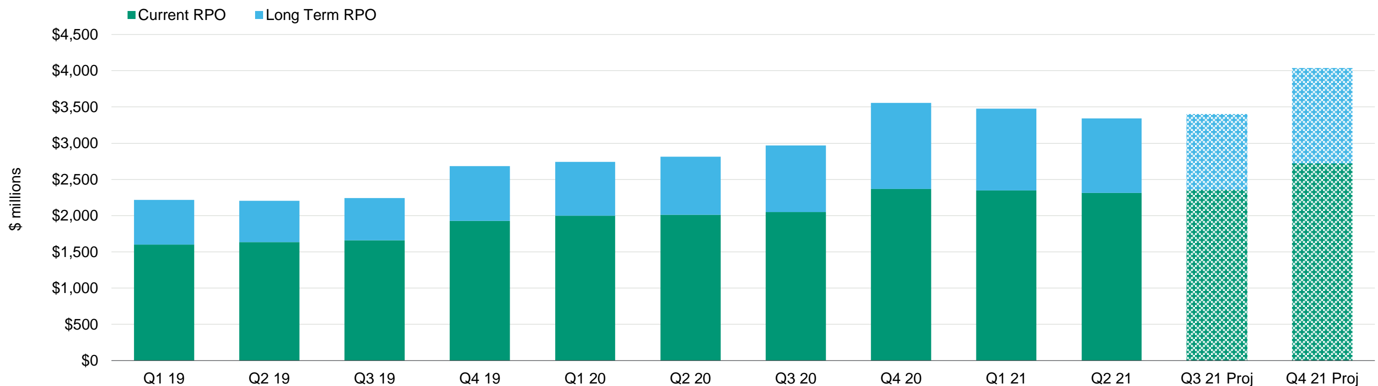
Sources: Autodesk, Moody's Financial Metrics™ and Moody's Investors Service projections

With 98% recurring revenue and the company largely through its multiyear transition to a subscription model, two key indicators of business strength are revenue and current remaining performance obligations (RPO). Current RPO is the amount of deferred revenue and contractually stated or committed orders under early renewal and multiyear billing plans for subscription, services, license and maintenance that revenue Autodesk expects to recognize in the next twelve months. We project current RPO will grow year over year by about 15% in the next two quarters (see Exhibit 2).

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.

Exhibit 2

Remaining performance obligations point to growth and steady performance

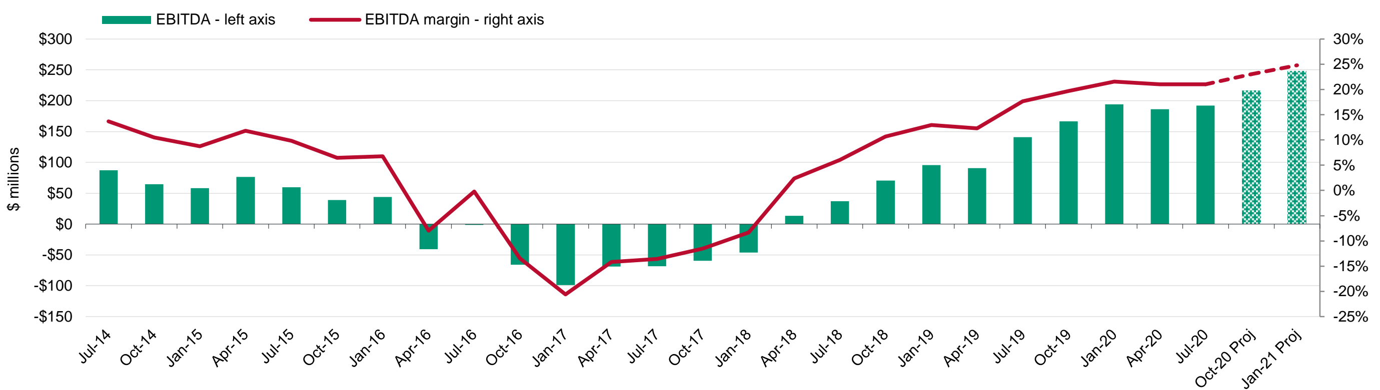


Sources: Autodesk, Moody's Financial Metrics™ and Moody's Investors Service projections

Combined with good cost controls but steady spending on research and development and ongoing investments to digitize the company, we project Autodesk's quarterly EBITDA will continue its uptrend after having completed its transition to a subscription model and average about $230 million during the rest of fiscal 2021, while average EBITDA margins approximate 24% (see Exhibit 3).

Exhibit 3

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

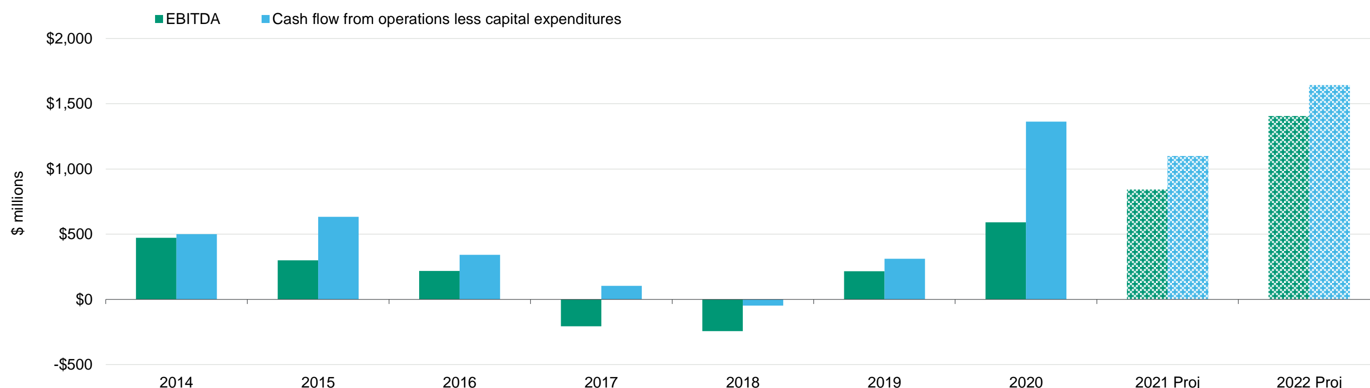


Sources: Autodesk, Moody's Financial Metrics™ and Moody's Investors Service projections

With Autodesk converting over 100% of its EBITDA into cash flow from operations less capital spending, and despite extending payment terms to help smaller customers preserve liquidity during COVID-19, we expect the company will generate over $1.0 billion cash flow after capital spending in fiscal 2021 (see Exhibit 4). Autodesk generates 10%-15% of revenue from small businesses, defined as customers with fewer than 20 employees and with fewer than 15 seats.

Exhibit 4

Cash flow from operations less capital spending will decline in 2021, but remain strong



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

Throughout fiscal 2021, Autodesk will maintain a very strong liquidity profile. Autodesk's next debt maturity is December 2022, when a $350 million note is due. As of July 2020, Autodesk had cash and short-term investments of $1.5 billion. Given the modest capital intensity of its software business and very strong cash flow generation even during periods of economic stress, the company's liquidity profile is very strong. The company also maintains access to a $650 million credit facility that matures December 2023.

Even during a very challenging macro environment, we project leverage will improve as earnings grow and debt declines. We project adjusted gross debt to EBITDA of about 2.4x at the end of fiscal 2021, down from 4.3x one year earlier. Similarly, the company's free cash flow to adjusted gross debt is projected to remain over 50%.

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Emerson's acquisition of Open Systems International is credit negative

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On 27 August, Emerson Electric Company (A2 stable) announced it had entered into an agreement to purchase Open Systems International, Inc. (OSI) for $1.6 billion in cash. OSI is a grid automation software solution provider for utilities, which Emerson intends to integrate into its Automated Solutions segment. We view the planned transaction as credit negative because of the size of the purchase price relative to expected earnings contributions as well as Emerson plans to fund the acquisition through additional debt and use of its cash balances, but it does not affect Emerson's ratings or outlook. The company expects the transaction to close early in its fiscal year ending September 2021.

The OSI acquisition fits well within expected levels of acquisition activity for Emerson and is likely to provide benefits to enhance Emerson's long-term growth plans in the utility sector. However, the $1.6 billion purchase price represents a significantly higher multiple of expected financial contribution from OSI than prior transactions: close to 9x 2020 revenue, versus revenue multiples in the 1.5x to 4x range for Emerson's acquisitions from fiscal years 2017 through 2019. As a software company, we expect OSI's margins to be relatively strong, but its total earnings contribution will still be modest when compared to Emerson's total operating income of $2 billion to $3 billion annually.

Although the company has not announced detailed funding plans for the OSI acquisition, we expect this would entail a combination of additional debt and use of cash balances, and will likely have a modestly leveraging effect. Emerson's debt/EBITDA was approximately 2.1x as of June 2020, close to our long-term expectations that leverage would be maintained close to or below 2.0x but slightly higher than 2019 levels because of lower earnings and an increase of debt by $750 million in 2020 to bolster cash, both related to the COVID downturn.

Depending on the amount of debt raised to fund the OSI acquisition, we believe this investment could push pro forma leverage toward the mid-2x range. With cash reserves lowered from the transaction (although still expected to remain close to $1.5 billion over the long term), we believe that Emerson will be more reliant on earnings growth over the next year to reduce leverage to 2.0x or below. As well, this reduces the company's capacity to raise debt for other investments and/or shareholder returns over the next year while maintaining its conservative leverage policies.

Nonetheless, we recognize the strong strategic rationale behind Emerson's acquisition of OSI. This transaction will enhance Emerson's presence in the global power industry, especially toward customers engaged in integrating renewable energy sources into power distribution networks where OSI's software offerings help to digitize operations and make integration more efficient. OSI not only has the potential to expand Emerson's opportunities in the power sector, but it will also enhance the company's participation in the renewable energy segment of the energy sector.

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GoodRx's planned IPO is credit positive

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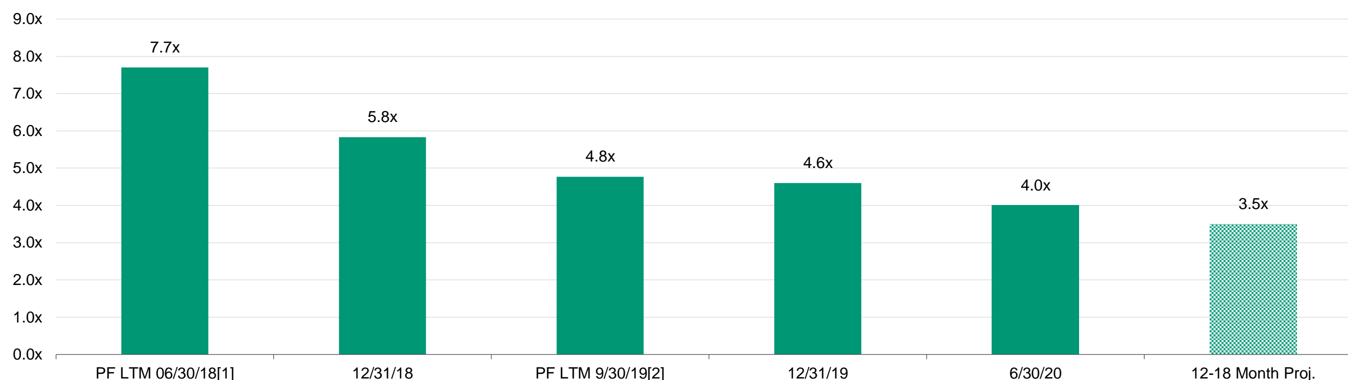
On 28 August, GoodRx, Inc. (B2 stable) filed a registration statement with the US Securities and Exchange Commission announcing its intention to launch an initial public offering (IPO) of common stock of parent company, GoodRx Holdings, Inc. The filing is credit positive because, if completed, it would increase the company's financial flexibility through access to public equity markets. In addition, we expect that the IPO will reduce the stake owned by private equity, facilitating a transition to a governance structure more characteristic of public companies – which typically have a strategy of managing to lower leverage. Although this development is credit positive, there is no immediate effect on the company's ratings or outlook.

We will assess the impact on the ratings as further details of the planned IPO emerge, in particular the likely amount of proceeds, as well as the planned use of the proceeds. The timing of the IPO has not been specified, and the plan remains subject to capital market conditions.

In addition to the IPO, we expect growth in GoodRx's profit and cash flow to continue to facilitate deleveraging. The company's adjusted debt/EBITDA as of 30 June 2020 was 4.0x, down from 7.7x roughly two years ago (see exhibit). For the six month period that ended June 2020, GoodRx recorded 48% growth in total revenue and 35% growth in adjusted EBITDA from the prior-year period.

GoodRx's solid EBITDA growth has resulted in meaningful deleveraging over the last 2 years



[1] Pro forma for company's LBO in September 2018
[2] Pro forma for prepayment of second lien term loan with $50 million of cash and incremental first lien borrowings
Sources: Moody's Financial Metrics™ and Moody's Estimates

GoodRx has benefited from the ease of use of its services and its digital platform. Furthermore, once GoodRx captures a new customer, the associated revenue with that customer tends to be recurring. Management estimates that a majority of prescription fills (which closely approximate revenue) are for chronic conditions that are refilled on a recurring basis. Consumers have readily adopted GoodRx's platform to obtain more favorable prescription drug pricing, whether it is because they lack prescription drug insurance or because they belong to a high deductible plan. We expect GoodRx to continue to benefit from strong growth over the next 12-18 months, supported by these trends.

However, GoodRx's credit profile remains constrained by its high degree of business risk. The company relies on pharmacy benefit managers (PBMs) for both supply and revenue. GoodRx essentially acts as an outside sales force to PBMs who allow the company to offer consumers access to their cash networks. This dependence on PBMs is a pronounced risk, particularly as PBMs, and drug prices in general, come under increasing scrutiny. We anticipate that US drug price scrutiny will remain high, which, while not having a direct impact on GoodRx, could have a substantial indirect effect should PBMs come under pressure. A reallocation of the economics

between GoodRx and its PBM customers could significantly compress earnings, particularly given that three PBMs account for a significant percentage of revenue.

Headquartered in Santa Monica, California, GoodRx owns and operates a prescription drug price comparison platform. The platform uses pricing data from PBMs to compare prices at local and mail-order pharmacies. Private-equity sponsor Silver Lake Partners acquired a 35% minority stake in GoodRx in August 2018, and controls the company along with equity sponsors Francisco Partners and Spectrum Equity and the company's founders and management team. The company generated approximately $472 million of revenue for the 12 months that ended 30 June 2020.

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UK anti-alcohol lobby calls for higher pricing and ad restrictions, a credit negative for manufacturers

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On 25 August, UK anti-alcohol lobby group Alcohol Health Alliance UK (AHA), published a report criticising existing alcoholic beverage labelling and calling for an increase in the minimum alcohol unit price and broader restrictions on alcohol advertising.

Additional regulation would be credit negative for the alcoholic beverage manufacturers operating in the UK including spirits producers Diageo PLC (A3 stable) and Pernod Ricard S.A. (Baa1 stable). We estimate Diageo generates around 9.5% of its total net revenue in the UK and less than 3.5% for Pernod Ricard. Brewers Heineken N.V. (Baa1 stable) and Carlsberg Breweries A/S (Baa2 stable) generate around 5% and 4% of total net revenue, respectively, from UK sales. A further increase in minimum pricing would result in higher selling prices and lower sales volumes for these companies.

Analysis carried out by the University of Sheffield for the AHA in 2012 and presented to the UK government's Health Select Committee showed that a minimum unit price of 50 pence would reduce alcohol consumption by around 6.7%. [1]

Alcoholic beverage companies' debt ratios are already weak because most of their restaurant and bar sales — known as on-trade sales — have been lost amid coronavirus lockdowns. In most markets where lockdown restrictions have eased, recovery has been tentative. On-trade sales account for between a third and half of companies' total sales, depending on the region. Premium spirits companies like Pernod Ricard are also adversely affected by ongoing travel restrictions, which have all but halted duty free sales. Tighter government regulations on the sale and marketing of alcoholic drinks would slow what we expect will be only a gradual recovery of credit quality. A positive counter-effect of bans and limits on advertising is that the measures would tend to benefit stronger brands and companies at the expense of newer market entrants.

Diageo's Moody's-adjusted net debt/EBITDA ratio is well over 4x and rising, well above the 3.25x upper guidance we expect for its current A3 rating. The debt ratios of other beverage companies will also remain elevated this year and next as a result of lower demand. For example, Heineken's leverage will peak at 6.2x this year and then gradually move back to the around 3.75x we expect for its Baa1 rating. Companies will at least partly offset any increased taxes or decline in sales because of higher minimum unit prices or increased restrictions with price increases. However, while off-trade sales have increased amid lockdowns as consumers purchased more alcohol in supermarkets to consume at home, off-trade demand is less elastic and tends to be lower margin.

Additional regulatory scrutiny also increases social risk for the alcoholic beverage sector. The sector is one we have identified as having high exposure to demographic and societal trends and customer relations in our social risk heat map because of concerns about alcohol abuse and increased scrutiny of marketing practices. The exposure makes the alcohol sector sensitive to socially driven policy agendas, which can lead to significant changes in business conditions. The AHA believes existing controls to limit alcohol advertising are failing and do not take into account the growth of marketing through digital, online and social media platforms. The AHA also said the alcohol industry's social responsibility body is failing to exercise proper oversight over its members' marketing practices.

In response to the AHA's claims, the Portman Group, the UK alcohol industry's marketing regulator and social responsibility body, stated that the report was biased and based on out-of-date information.

Endnotes

1 **Health Committee Written evidence from Alcohol Health Alliance UK (GAS 27)**, May 2012.

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The Hut Group's planned IPO is credit positive

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On 27 August, The Hut Group Limited (THGL), the parent company of THG Operations Holdings Limited (THGO, B1 stable), announced its intention to proceed with an initial public offering (IPO) on the London Stock Exchange, subject to market conditions. A successful IPO would be credit positive for THGO because, according to the company, it would result in a net cash position of about £320 million. This compares to THGO's net funded debt of approximately £370 million at the end of 2019. At this stage it is unclear whether the company intends to keep in place THGO's £510 million term loan B, due in 2026.

If THGL decides to proceed with the IPO, the offer would comprise the issue of new shares with targeted gross proceeds of around £920 million, and an offer of existing shares to be sold by certain existing shareholders. Immediately following the IPO, the company intends to have a free float of at least 20% and a pre-money equity value of approximately £4.5 billion.

THGO was established last year as the holding company of the newly established operational sub-group of THGL, which had decided to ring-fence its property assets into a separate "Propco" sub-group. The company is headquartered in Manchester, England, and has a diverse range of e-commerce focused activities, and certain associated manufacturing facilities. Its largest brands, lookfantastic.com and myprotein.com, operate in the beauty and wellness retail segments, respectively. THGO's technology platform, Ingenuity, was developed initially to support the company's own online retail activities but now also offers its suite of services to third parties.

The company has a multiyear history of very strong revenue and profit growth, driven by a combination of both organic expansion and acquisitions. A significant proportion of the growth has been achieved outside the UK, with 65% of THGL's 2019 revenue of £1.1 billion generated internationally.

The company's announcement regarding the planned IPO details continued strong growth across all divisions of THGO during the six months that ended in June 2020. The company's pure online focus will have helped as competitors with stores endured closures during coronavirus-driven lockdown restrictions. Revenue of £676 million in the period was 35.7% higher than in the first half of 2019, while the company's reported adjusted EBITDA grew 27.1% to £60.5 million. We note, however, that exceptional costs – reported by the company below its adjusted EBITDA – increased materially during the period. As usual, we want to understand the nature of these costs to determine whether we agree that they were exceptional in nature.

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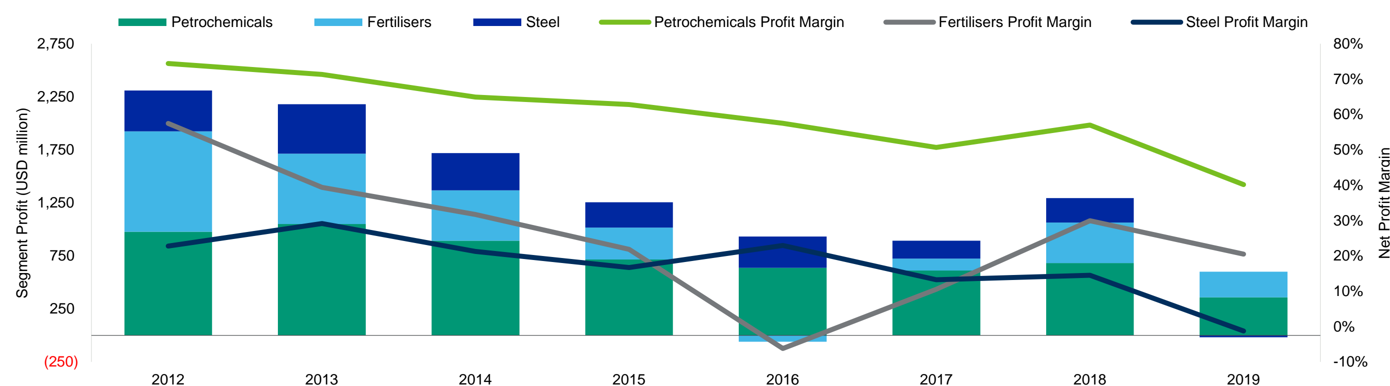
Industries Qatar's plan to take full control of QAFCO with 25% stake purchase is credit positive

On 23 August, Industries Qatar Q.P.S.C. (IQ, A1 stable), which owns a 75% stake in Qatar Fertiliser Company (QAFCO), said that it will buy the remaining 25% stake in QAFCO from Qatar Petroleum (QP, Aa3 stable) for $1 billion,[1] giving it sole ownership of the world's largest single-site urea producer. The acquisition, which requires shareholder approval, would be credit positive for IQ because it will gain full strategic, operational and financial control over QAFCO and 100% of its dividends, which will increase IQ's attributable net profit. IQ will fund the acquisition with cash balances at a time when the IQ group has almost no financial debt outstanding.

IQ's fertiliser business segment, effectively the QAFCO operation, is an important earnings contributor to the IQ group, despite its volatility (see Exhibit 1). We estimate that IQ's attributable net profit would have been 11% higher for 2019 pro forma if QAFCO was fully owned by IQ instead of 75%.

Exhibit 1

Petrochemicals and fertilisers operations have historically been the key earnings contributor for IQ

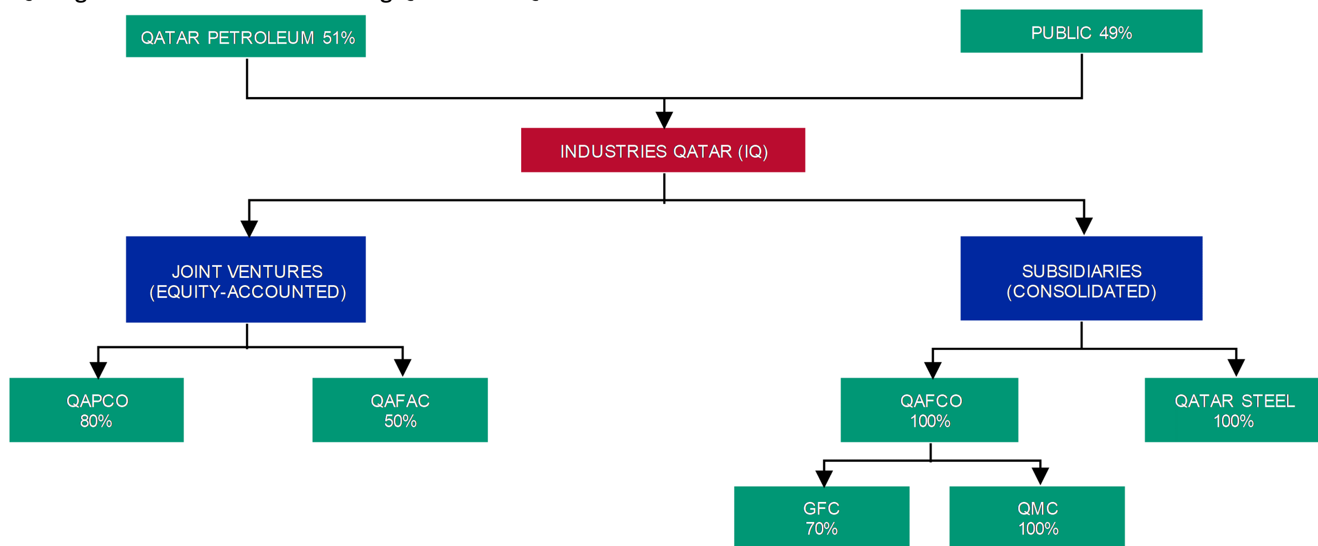


Sources: IQ's financials and Moody's Investors Service

As part of the transaction, QAFCO will acquire QP's 40% stake in Qatar Melamine Company (QMC), a key subsidiary of QAFCO. Both QAFCO and QMC have also entered into a new gas sale and purchase agreement (GSPA) with QP. The GSPA is effective until 2035 and covers the natural gas needs of both companies. The new GSPA provides feedstock to QAFCO and QMC under a more simplified, competitive and favourable arrangement compared to the prior agreements. The new GSPA will slightly improve QAFCO's cost position because it will buy natural gas feedstock from QP at a cheaper rate on average than previously. Under the announced transaction, the 25% stake that IQ is buying will revert back to QP in December 2035, once the GSPA expires.

The company will have an extraordinary general assembly meeting in the coming weeks to seek shareholder approval for the acquisitions of the QAFCO and QMC stakes (see Exhibit 2) and to authorize IQ's board of directors to negotiate and take appropriate action in the future regarding IQ's rights in its other joint ventures. We believe that IQ will have the opportunity to buy the remaining 20% stake in Qatar Petrochemical Company (QAPCO) and the remaining 50% stake in Qatar Fuel Additives Company (QAFAC) from its joint venture partners when shareholder agreements expire in the coming years. Should this occur, the acquisitions would give IQ significant flexibility to make strategic and investment decisions across its portfolio of companies, and give it full control of financing and dividend distribution decisions. In addition, the acquisitions would improve analytical transparency because current joint venture operations are equity-accounted in IQ's financial statements.

Exhibit 2
IQ's organizational structure following QAFCO and QMC stake increases



[1] Along with QMC, Gulf Formaldehyde Company ("GFC") is a key subsidiary of QAFCO
Source: Moody's Investors Service

IQ's substantial cash position and minimal debt obligations give the company significant financial flexibility to consolidate ownership in its joint ventures. IQ reported a cash balance of $3.1 billion as of 30 June 2020. This amount consolidates cash held at QAFCO and Qatar Steel level, and on average, 65%-70% of the cash has historically been held at the IQ holding company level.

Endnotes

1 QP purchased the 25% stake in QAFCO for $1 billion from Yara International ASA (Baa2 stable) on 8 March 2020. Yara had been the joint-venture partner in QAFCO since 1969 until the shareholder agreement expired at year-end 2019.

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Asahi's equity issuance to help repay bridge loan is credit positive

Originally published on 27 August 2020

On 25 August, Asahi Group Holdings (Baa1 negative) announced that it will issue up to ¥157.5 billion ($1.5 billion) of new equity to replace a part of a ¥1.185 trillion bridge loan it took on to acquire Anheuser-Busch InBev SA/NV's (Baa1 stable) Australian beer business, Carlton & United Breweries (CUB), in June 2020. Asahi paid AUD16 billion (about ¥1.2 trillion) in cash for this acquisition. The company plans to complete the equity issuance by mid-September 2020, excluding overallotment.

The announced equity issuance is credit positive because it will help reduce Asahi's debt, largely in line with its financing planning and removes uncertainty on replacing a part of the bridge loan with equity financing. At closing of the acquisition in June 2020, we expected Asahi's leverage – as measured by debt/EDITDA – to increase to over 7.5x for 2020, more than doubling its 2019 leverage of 3.2x and above its downgrade trigger of 3.5x. Reflecting Asahi's first half result and its earnings estimate of 2020 announced in early August, which was better than our initial estimate, we now expect Asahi's leverage in 2020 to be around 7.3x.

The current Baa1 rating incorporates Asahi's financing plan to raise ¥300 billion of equity-like permanent financing, including up to ¥200 billion of common equity and up to ¥300 billion of hybrid subordinated debt with equity-like features, to replace a part of the bridge loan. This financing will help reduce Asahi's leverage in the coming years, along with the projected demand recovery after easing of disruptions caused by the coronavirus outbreak. We expect Asahi to raise the remaining amount for the bridge loan with hybrid subordinated debt. For this subordinated debt, the execution is less uncertain than the equity offering because Asahi has already secured ¥400 billion subordinated loan committed by a group of Japanese banks as a backup.

Despite improved clarity on the permanent financing, the negative outlook still captures the uncertainty surrounding the company's demand and profit recovery in the next couple of years, and whether Asahi can improve its leverage below 3.5x, the current downgrade trigger, by the fiscal year that ends 31 December 2022 (fiscal 2022).

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Scentre Group's first-half 2020 results reflect coronavirus disruptions and are credit negative

Originally published on 26 August 2020

On 25 August, Australia-based mall owner Scentre Group (A2 negative) reported first-half 2020 results that highlighted the difficulties for retail landlords from disruption caused by the coronavirus pandemic and are credit negative.

Reported EBIT declined by a considerable 33% from a year earlier to AUD637.4 million. The decline primarily reflected an expected credit charge relating to the coronavirus pandemic of AUD232.1 million, although asset sales in 2019 also led to lower earnings. Of the expected credit charge, management has indicated that around one-third has been utilised and largely reflects waived rent.

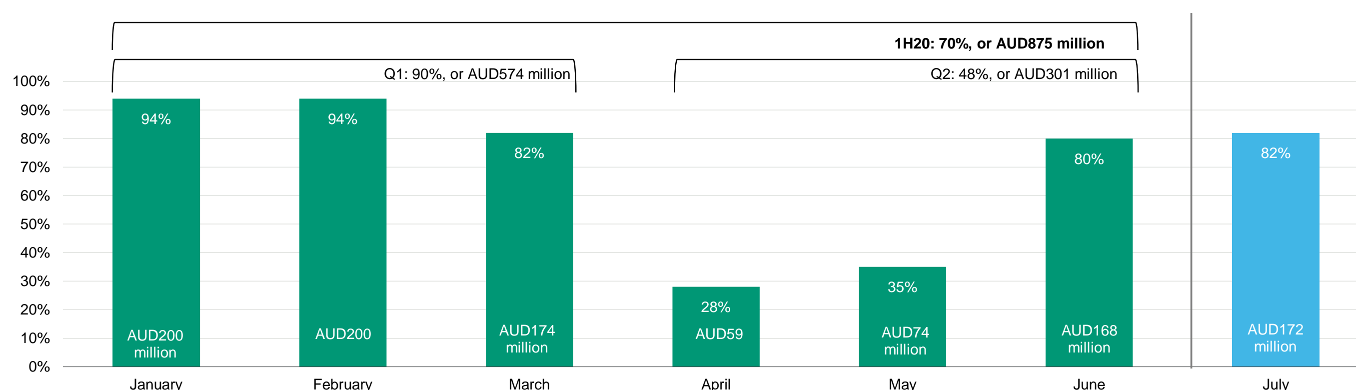
Operating cash flow of AUD210.8 million for the period was down more than 60% from the prior comparable period, as gross cash rent collection was 70% of gross rental billings. This, in large part, reflected the low cash collection rate of 48% for the June quarter, which was weighed down by very low collection rates of 28% for April and 35% for May, the two months during which the strictest government restrictions were in place.

While the effects from the coronavirus materially weakened Scentre's cash collections in the first half of 2020, collections have started to improve more recently, holding at or above 80% for June and July. Scentre has stated that August is tracking similar to these levels. This, coupled with store openings and customer visitations recovering toward pre-coronavirus levels, should underpin higher cash flow for the second half of 2020 and through 2021.

We expect cash rent collection (see Exhibit 1) to return to more normal levels once Scentre works through its remaining negotiations with its retail tenants. The group reported that through 20 August it had agreed arrangements with 2,438, or around 68%, of its 3,600 retail partners. This included completing negotiations for over 60% of its small and midsize enterprise tenants, which are entitled to rent reductions in line with reduced revenue as part of a code of a code of conduct implemented by the Australian government.

Exhibit 1

Scentre's gross rent cash collections have improved over recent months following the significant declines at the onset of the coronavirus outbreak



Total billings before any application of the SME Code of Conduct are used for the above calculation of percentage of rent cash collection

Source: Company reports

While these agreements include waiving rental payments on a case-by-case basis, importantly for Scentre's ongoing credit profile, the group has confirmed that the overall structures of the leases with its tenants has not changed and remains based on the mutual agreement to pay fixed rent, with escalations. Also supportive for its ongoing credit profile, the group reported that it is extending the maturity profile of some of its leases up to three years as part of the agreements being negotiated.

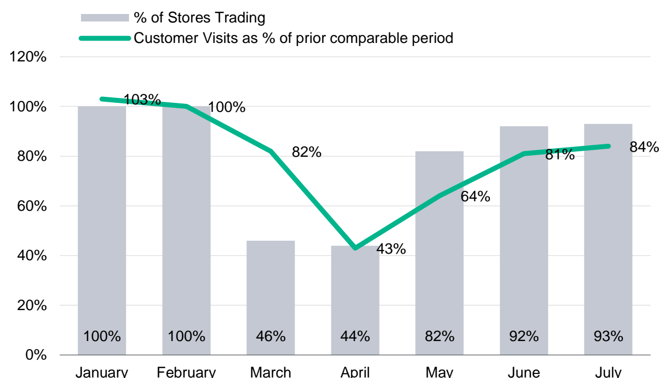
Specialty in-store sales and total in-store sales were both down materially in the period, by 12.1% and 8.1%, respectively. However, these metrics have also started improving as restrictions outside the Australian state of Victoria have eased and consumers return to shopping centres. The group stated that in-store sales for the Australian portfolio, including Victoria, where restrictions have been tightened again, were higher in July than the previous year for both measures.

Scentre's occupancy rates held up reasonably well at 98.8%, which was down from 99.3% a year earlier. We expect further difficulty maintaining occupancy rates to emerge as tenants continue to face unprecedented stress, which will likely lead to further store closures and retailer bankruptcies.

There has been a good recovery in customer visitation and store openings across Scentre's portfolio. In the month of July, customer visitations and store openings have recovered close to pre-coronavirus levels in Australia (see Exhibits 2 and 3). Excluding Victoria, these measure were at 84% and 93%, respectively, for the Australian assets. Scentre has a relatively lower exposure to Victoria, with around 15% of its assets by value located in that state. Including Victoria, customer visitations and store opening metrics shows a slight further reduction to 80% and 88%, respectively. Scentre's New Zealand assets showed strong recovery with July numbers showing 100% of stores open and customer visitation exceeding previous corresponding levels.

Exhibit 2

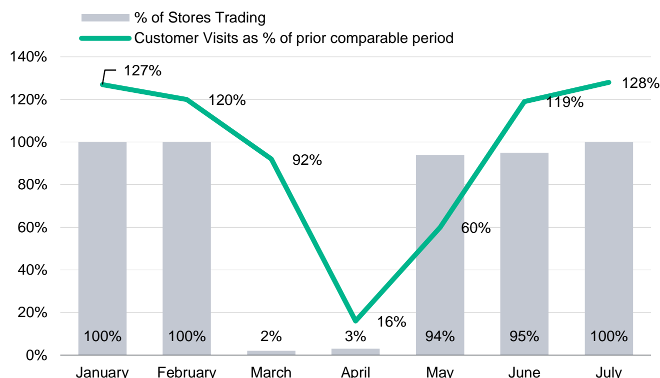
Scentre's customer Visitation and Store Openings in Australia



Note: Figures shown for July excludes Victoria. Including Victoria 88% of stores were trading and customer visits were 80%
Source: Company reports

Exhibit 3

Scentre's customer visitation and store openings in New Zealand



Source: Company reports

Reflecting weaker earnings prospects for its retail assets and increasing capitalisation rates, Scentre also reported a 10%, or AUD4.08 billion, devaluation across its property portfolio. This, combined with higher net debt levels, resulted in reported gearing rising to 38.4% from 33.0% at December 2019. Adjusted net debt/EBITDA for the last 12 months to 30 June also weakened to around 8.5x, while interest coverage decreased more modestly to around 3.0x. Excluding expected credit charges related to the coronavirus outbreak, adjusted net debt/EBITDA was 7.4x and interest coverage was 3.4x for the 12-month period.

Scentre's recent balance sheet initiatives to improve liquidity and pre-fund debt maturities support its credit profile amid a challenging operating environment. During 2020, the group raised or extended AUD5.8 billion of additional funding, including AUD3.4 billion of bank facilities and AUD2.4 billion of long-term bonds. The group currently has available liquidity of AUD4.4 billion, sufficient to cover all maturities to January 2023.

The group's ability to maintain an appropriate credit profile for its ratings will ultimately reflect its ability to continue to add on to the recent improvements in operating performance over the next 12-18 months, such that earnings increase back towards historical levels. To the extent that earnings are likely to remain at weaker levels, we expect Scentre to reduce debt levels to maintain financial metrics in line with our expectations for its ratings.

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Banco Davivienda issues its first gender-linked bond based on achieving outcomes

Originally published on 28 August 2020

On 25 August, Colombia-based Banco Davividenda S.A. (Baa3 negative/Baa3, ba1[1]) issued its first gender-linked bond based on achieving outcomes. Davivienda will use proceeds from the $100 million seven-year bond to fund loan growth in its women-led small and midsize enterprise (SME) portfolio and women's acquisitions of social housing in Colombia, a credit positive.

Although the issuance is less than 0.5% of Davivienda's current gross loans, the segment has significant growth potential and will align the bank's environmental, social and governance (ESG) business objectives with principles of the International Association of Capital Markets and with the Women Entrepreneurs Financing Initiative, an alliance to unlock financing and provide market access for women-led companies. In addition, we expect it will expand the market and investor base for socially conscious sustainable assets and financial instruments.

Inter-American Investment Corporation (IDB Invest, Aa1 stable), the private-sector arm of the Inter-American Development Bank (IADB, Aaa stable), purchased the bond in full. IDB Invest will grant Davivienda a $300,000 bonus over five years if it expands its women-owned SME loan portfolio to 27% as of 2026 from 20% as of December 2020. The bonus will be disbursed annually in $60,000 increments following progress assessments. The transaction reflects the multilateral credit agents' commitment to financial inclusion and gender equity in Latin America. Davivienda's gender bond is the second of its kind in Latin America and according to IDB, the first based on achieving outcomes.

Davivienda is Colombia's second-largest bank and has a 17% share of the domestic loan market. SMEs account for around 10% of its total domestic loan book, and loans to women-led businesses comprise 20% of its total SME loan book. Davivienda is also a leader in housing finance and at year-end 2019 had a 32% market share of the government's financing programs for social housing, Vivienda de Interes Social. This issuance is the third deal between Davivienda and IDB Invest. In early 2018, IDB Invest granted a $200 million unsecured loan to support an increase in mortgage offerings promoted by the Colombian government as part of its social housing development programs. In 2011, it granted Davivienda a credit line of up to $30 million to support an expansion of its Colombia-based SME loan book. In addition, earlier this year, Davivienda received funding from the International Finance Corporation (Aaa stable) for $335 million and from the OPEC Fund for International Development for $50 million to support the financing of women-led SMEs, social housing and sustainable construction projects in Colombia.

This gender bond issue strengthens Davivienda's ESG credentials at a time when the coronavirus pandemic is increasing attention on corporate social behavior, and banks are beginning to shift their strategies from shareholder primacy to a greater emphasis on the needs of other stakeholders, such as their clients, employees and broader society. Additionally, the potential consequences of not acting on significant ESG risks will have enduring implications for assessing credit risk. Davivienda has included sustainability as one of its strategic goals, has committed itself to the United Nation's Sustainable Development Goals and is part of the Dow Jones Sustainability Index.

Endnotes

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

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Hamburg Commercial Bank's results show credit-positive progress toward becoming a private bank

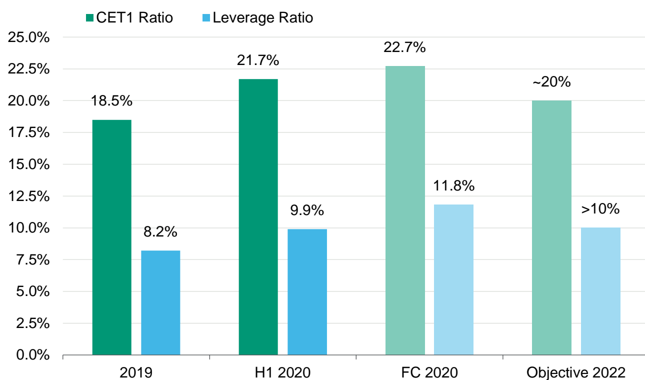
On 27 August, Hamburg Commercial Bank AG (HCOB, Baa2/Baa2 stable, ba2[1]), the successor bank of Landesbank HSH Nordbank AG, reported financial metrics that point to the bank continuing to make progress in transitioning to full membership in the Association of German private banks (BdB) from a public savings, a credit positive.

HCOB reported a regulatory Common Equity Tier 1 (CET1) capital ratio above 20%. Supported by continued deleveraging and limited new business activity in a challenging operating environment brought on by the coronavirus pandemic, the bank's decline in risk-weighted assets led to a strong improvement in its fully loaded CET1 ratio to 21.7% from 18.5% in December 2019 (see Exhibit 1), and has resulted in the bank very comfortably exceeding its capital requirements (see Exhibit 2).

Exhibit 1

HCOB's capitalisation improved in first-half 2020...

CET1 and regulatory leverage ratios as a % of risk-weighted assets and leverage ratio denominator

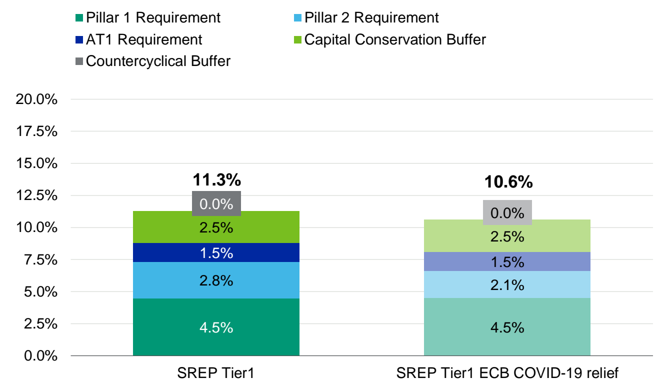


Sources: The bank and Moody's Investors Service

Exhibit 2

... and comfortably exceeds its capital requirements

HCOB's Supervisory Review and Evaluation Process (SREP) Tier1 capital requirements as a % of risk-weighted assets

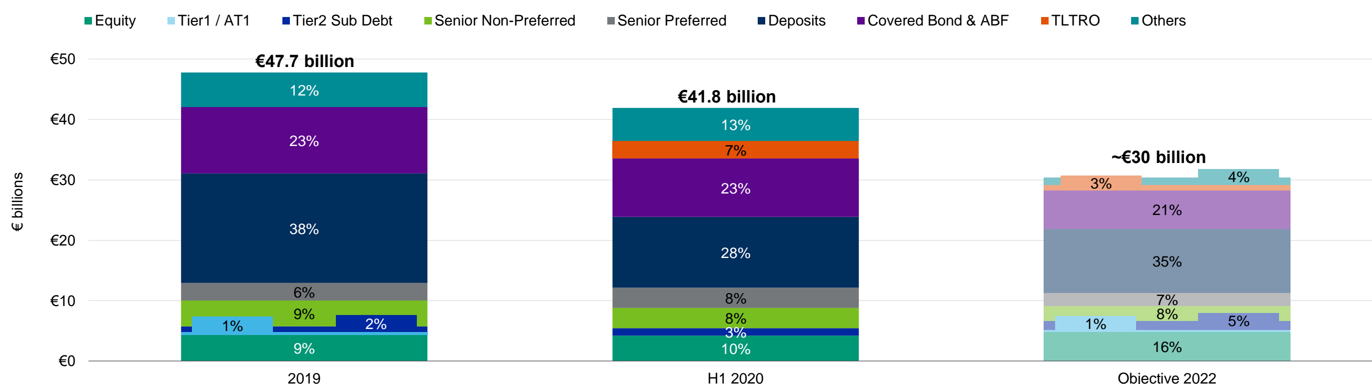


SREP Tier 1 ECB COVID-19 relief = accelerated eligibility of Tier 2 capital to partially fulfill the Pillar 2 requirement

Sources: The bank and Moody's Investors Service

The CET1 capital ratio will be a key measure for the BdB when it assesses HCOB's preparedness to join its voluntary deposit protection fund as a full member[2] after year-end 2021. The targeted smooth transfer of HCOB out of Sparkassen-Finanzgruppe's (S-Finanzgruppe, Aa2 negative, a2[3]) institutional protection scheme will give HCOB additional flexibility in transforming its funding structure (see Exhibit 3).

Exhibit 3
HCOB's liability structure by instrument as a % of total liabilities and equity

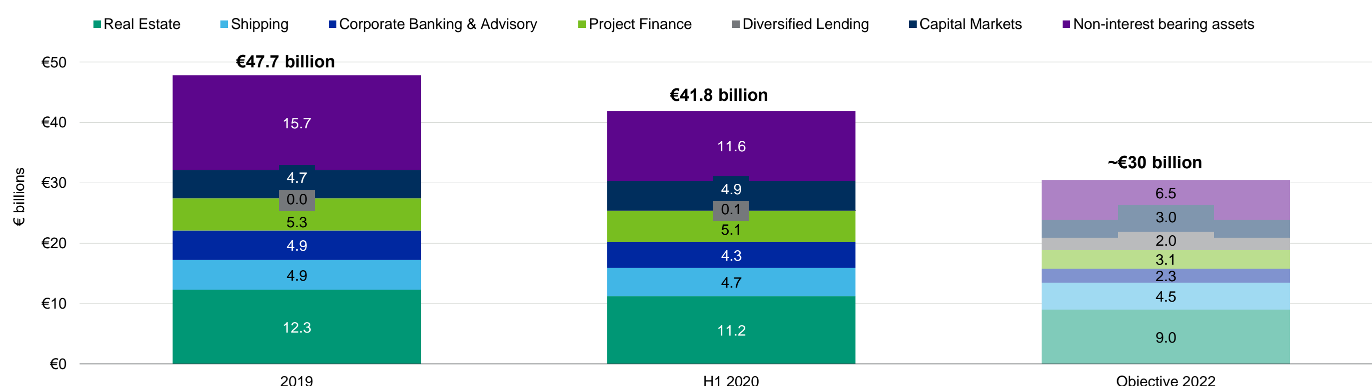


Key: AT1 = Additional Tier 1 capital; ABF = Asset-based funding; TLTRO = Targeted longer-term refinancing operations
Sources: The bank and Moody's Investors Service

HCOB's strong emphasis on optimizing asset profitability is reflected in its fast deleveraging, particularly through the reduction of noninterest bearing and low-yielding assets. Underlying operating results benefit from strong cost reduction discipline, lower funding costs and a focus on changing its asset mix toward higher-margin lending.

The strong decline in noninterest-bearing assets (see Exhibit 4) includes a €2.5 billion reduction in the bank's cash position and a €488 million decline in receivables from banks. Against industry-wide inflation of fair values of trading derivatives assets as a result of market volatility, HCOB even slightly reduced this item by €175 million. The bank continued to shrink its real estate holdings through a disposal of €101 million of assets that were sold at a €71 million profit in February 2020. HCOB plans to dispose of and temporarily lease back its Hamburg, Germany, headquarters before year-end 2020, which is valued at €120 million in assets held for sale. Similarly, the bank sold €246 million in public-sector loans, generating a one-off profit of €37 million, and earmarked an additional €339 million public-sector loan portfolio for sale in the second half of the year.

Exhibit 4
HCOB's balance sheet composition by asset type



Sources: The bank and Moody's Investors Service

The bank plans to extend its growth in lending margins through a continued asset mix shift. According to the bank's plan, this will by 2022 lead to further, albeit moderate, growth of the role of asset-based financing within its portfolio, mainly of commercial real estate (CRE) and shipping loans.

High loan-loss provisioning positions the bank well to proceed with the restructuring of its asset base by providing leeway to dispose of more vulnerable assets within a lending portfolio with concentrated cyclically sensitive exposures.

HCOB's first-half one-off gains on real estate and loan book disposals have enabled the bank to be profitable while using management adjustments to book loan-loss provisions above the German industry average. HCOB reported net income of €4 million (versus €5 million a year earlier) based on a pretax result of €71 million (versus €96 million a year earlier). The bank's €94 million of loan-loss provisions (a net reversal of €25 million a year earlier) equal to an annualised cost of risk of 65 basis points of June 2020 gross customer loans, and the bank expects to further increase its provisioning levels in the second half of this year despite already-high management adjustment reserves.

HCOB's reported jump in its nonperforming exposure ratio to 3.2% from 1.8% as of year-end 2019 mainly reflects the bank's expectation that it will record in the near term one large commercial real estate loan below its prior book value, which required its impairment. Consecutively, a successful sale of this loan would reduce HCOB's nonperforming loan ratio. We expect the bank to continue to use its flexibility granted by its high coverage of problem loans through loan-loss reserves to dispose of more vulnerable assets in its lending book as needed. This flexibility is particularly valuable because we expect HCOB's target asset mix to remain geared toward exposures subject to a high degree of cyclicality.

Endnotes

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

2 HCOB has been a junior member since January 2019.

3 The ratings shown are S-Finanzgruppe's corporate family rating and Baseline Credit Assessment.

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Dismissal of US lawsuit against Danske Bank removes one hurdle, but risk of significant penalties remains

On 24 August, a US federal district court dismissed a civil lawsuit brought against Danske Bank A/S (A2 negative/A3 stable, baa2[1]) and certain former bank executives in the US alleging they misled investors regarding the extensive failures in anti-money-laundering (AML) controls at the bank's previous Estonian branch.

The dismissal of the lawsuit is credit positive for Danske because it eliminates one potential financial penalty for the bank. However, Danske is still exposed to potentially significant financial penalties from ongoing regulatory and legal proceedings related to allegations of money laundering at the bank's previous Estonian branch between 2007 and 2015. The now-dismissed complaint sought unspecified damages on behalf of a group of investors in the bank's American Depositary Receipts (ADRs)[2] between 9 January 2014 and 29 April 2019.

The bank remains under investigation by authorities in the US, Denmark, Estonia and France. Additionally, a number of other shareholder lawsuits are pending in connection to the Estonian case.

The potential fines and other regulatory penalties remain a key credit challenge for Danske. Previous deficiencies in compliance and controls were a key factor behind the bank's weakening profitability in recent quarters, as funding and operational costs increased as customer and investor confidence waned and spending on AML capabilities rose. The ultra-low interest rate environment, particularly in the bank's Danish home market, was also a source of negative pressure on profitability. The economic fallout from the coronavirus-induced disruption added to the bank's profitability challenges this year, and we expect those forces to continue over the next 12-18 months.

Moreover, as indicated by similar past cases and the reported number of regulators involved in the investigations, the prolonged and complex nature of the probes and remediation procedures will continue to consume a significant amount of managerial focus and bank resources.

However, the bank's capitalisation is solid: as of 30 June 2020, the bank's Common Equity Tier 1 (CET1) capital ratio was 17.6%. As a response to increased capital requirements and general uncertainty about future regulatory developments, the bank increased its short- to medium-term CET1 target to above 16% in 2019.

Past governance failures also manifest themselves in higher capital requirements: in October 2018, the Danish Financial Supervisory Authority (FSA) required the bank to set aside a minimum of DKK10 billion (around $1.7 billion) in Pillar II capital (in the form of CET1) to cover for what the Danish regulatory authority characterised as "heightened compliance and reputational risks." Danske also cancelled its share buyback program in response. In the third quarter of 2019, the Danish FSA ordered the bank to set aside an additional Pillar II add-on of DKK4 billion to reflect "general product governance risk following the Flexinvest Fri[3] investigation and increased risk following an inspection of the bank's IT governance structure."

Endnotes

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

2 ADRs are negotiable securities that allow US investors to trade non-US shares locally while receiving dividends directly in USD.

3 In June 2019, Danske found that it had overcharged customers investing in one of its products, Flexinvest Fri, over a certain period.

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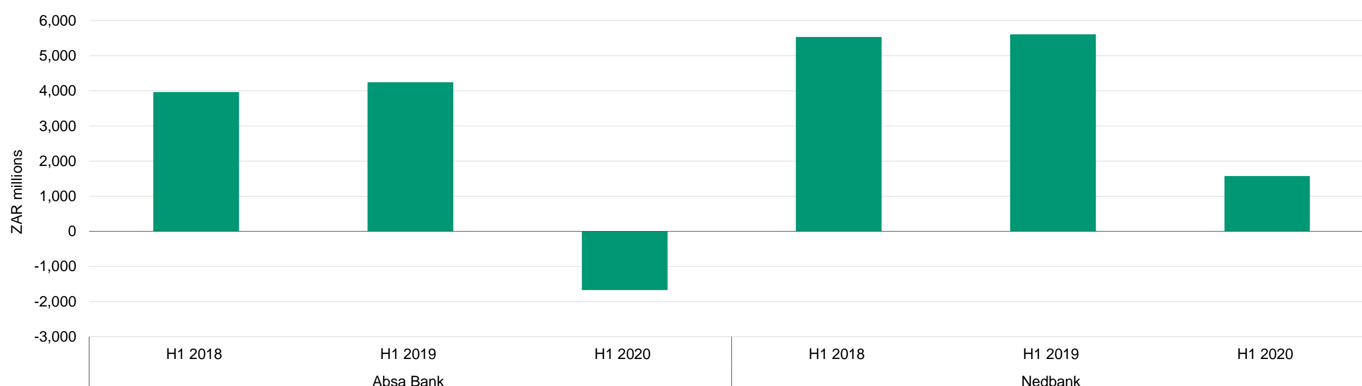
Pandemic and economic slowdown hurt Nedbank and Absa Bank's first-half profitability

On 26 August, Nedbank Group, the bank holding company of Nedbank Limited (Nedbank, Ba1 negative, ba1[1]) reported first-half 2020 results, two days after Absa Group Limited (Ba2 negative), the bank holding company of Absa Bank Limited (Absa, Ba1 negative, ba1) reported. Nedbank and Absa are two of South Africa's “Big Four” banks, and their profitability declined materially as the coronavirus-related economic slowdown prompted higher provisioning costs, increased nonperforming loans (NPLs) and lower Common Equity Tier 1 (CET1) capital ratios.

However, the banks maintained strong liquidity buffers and focussed on containing expenses, accelerating their digital transformation and protecting their balance sheet. As a result, we believe that they are in a position to navigate the current challenges without jeopardising their financial stability.

Nedbank reported a profit of ZAR1.6 billion, down from ZAR5.6 billion a year earlier, while Absa Bank reported losses of ZAR1.7 billion, versus a profit of ZAR4.2 billion a year earlier (see exhibit).

Absa Bank's and Nedbank's profitability weakened significantly in first-half 2020
The banks' net income



Source: The banks

For both banks, increased provisioning costs eroded results, with South African banks the most aggressive among African banks in implementing IFRS9 requirements. Those requirements mandate that banks take provisions based on expected credit losses, even if a loan is performing.

Nedbank's provisions increased to around 1.8% of gross loans or ZAR7.4 billion versus ZAR2.5 billion a year earlier, while Absa Bank's provisions increased to around 2.5% of gross loans or ZAR11.2 billion versus ZAR2.9 billion a year earlier. Both banks' provisions for the first half of this year were higher than those during the global financial crisis. Asset quality metrics also deteriorated, with Stage 3 loans[2] comprising 5.7% of gross loans at Absa Bank and 4.6% for Nedbank; similarly, there was an increase in Stage 2 loans to 10.6% of gross loans for Absa Bank and 12.3% for Nedbank.

Both banks' CET1 ratios declined, but still exceed regulatory minimum requirements. Nedbank's CET1 fell to 9.9% (11.2% in December 2019), below the bank's target range of 10%-12%, and Absa Bank to 10.6% (11.9% in December 2019), below its target range of 11%-12%. Reduced capital generation, a 2019 dividend paid by both banks in first-half 2020 and an increase in risk-weighted assets that largely reflected the migration of Stage 1 and 2 loans to Stage 2 and 3 drove the declines in the CET1 ratios.

Despite pressure on profitability, asset quality and capital, the banks' results showed sound funding and liquidity. At the group level, Absa Group reported a liquidity coverage ratio of 126.6% and a net stable funding ratio (NSFR) of 117.1%, while Nedbank Limited's liquidity coverage ratio was 117.0% and its NSFR was 109.3%. South African banks are also investing in alternative forms of liquid assets as they reduce their reliance on the South African Reserve Bank's (SARB, the central bank) committed liquidity facility that will end by 2021.

Operating income fell just 2% for Nedbank and 1% for Absa Bank despite less client activity and 275 basis points of central bank policy rate cuts that adversely affected the banks' net interest margins. Nedbank's operating expenses fell 1% and Absa's fell 7%. Both banks' management said that they have accelerated their digital transformation initiatives, a move that will have more sustainable benefits, and that they are focussing on protecting their balance sheets and supporting their clients, a sound strategy in the current environment.

We expect a similar material drop in profitability for full-year 2020, but with profits recovering in 2021. However, provisioning costs will likely remain elevated and above the through-the-cycle levels of less than 100 basis points. Also, we expect the banks to start rebuilding their capital buffers in 2021, although they will likely remain at the lower end target ranges.

In contrast, we expect NPLs/Stage 3 loans to continue rising through 2021 as the full effect of the pandemic takes hold and payment relief initiatives expire. Credit growth will remain muted over the next 18 months as banks' management focus on protecting balance sheets rather than growing their business. Funding and liquidity conditions should be stable, although there is always the risk of depositors shortening the maturity profile of their deposits if market conditions remain tight.

Endnotes

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

2 Credit exposures are classified within Stage 3, when they are regarded as being credit impaired, which aligns to the regulatory definition of default

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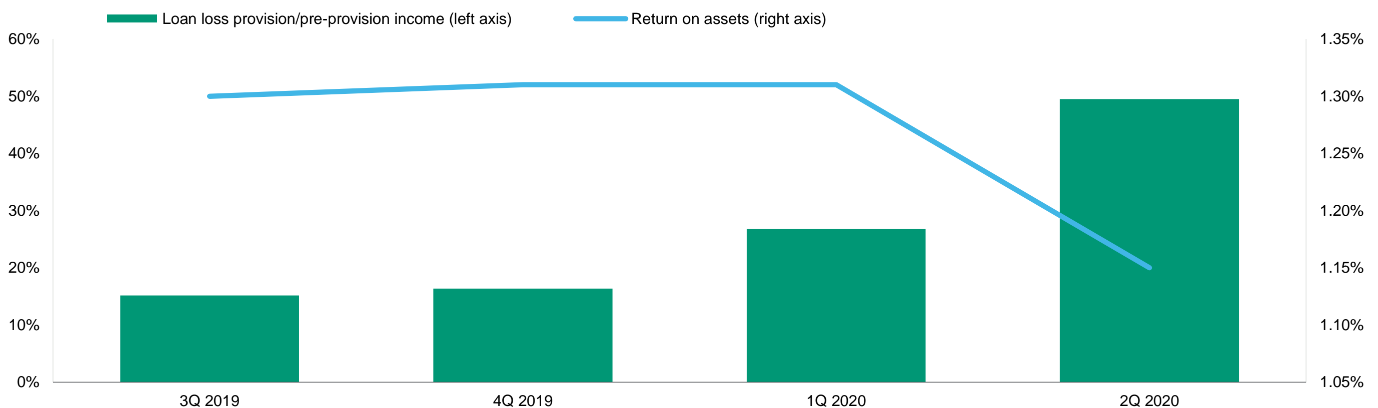
Philippines' proposed credit card interest rate cap is credit negative for banks

Originally published on 29 August 2020

On 24 August, the Bangko Sentral ng Pilipinas (BSP), the central bank of the Philippines (Baa2 stable), proposed capping finance charges for credit card cash advances and installment purchases at an effective annual interest rate of 24%.

The proposed interest rate cap is credit negative for Philippine banks because it will erode banks' profitability at a time of rising credit costs and problem loans amid the coronavirus pandemic (Exhibit 1). Banks will have to cut their existing credit card interest rates by about half from the current effective annual interest rates of more than 40% if the proposed interest rate cap of 24% is implemented.

Exhibit 1
Surge in credit costs in second quarter 2020 has weakened Philippines banks' profitability

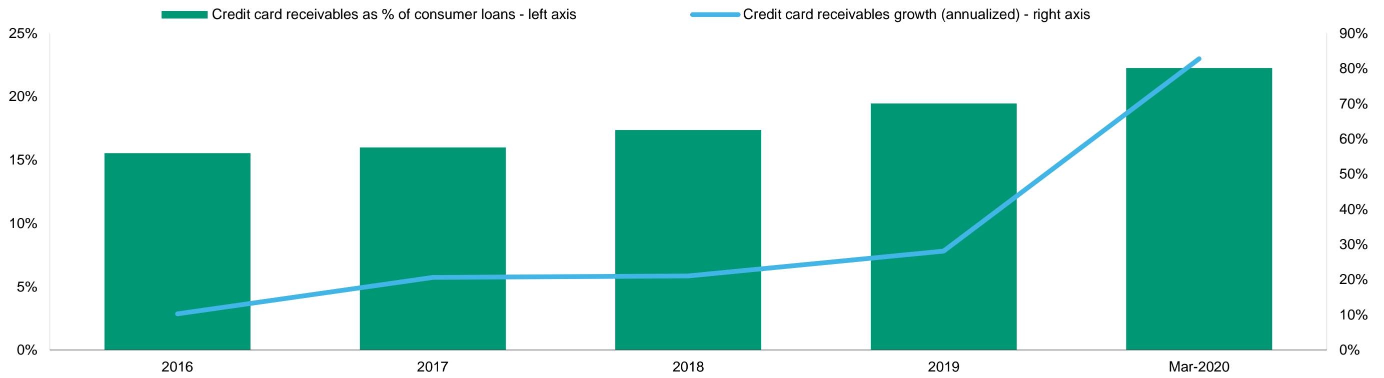


Second-quarter 2020 data is based on preliminary data from BSP
Source: Bangko Sentral ng Pilipinas

The cap on credit card interest rates will also undermine Philippine banks' growth strategies. Philippine banks' loan portfolios have traditionally been heavily weighted toward large corporates. To enhance their yield and diversify their corporate-centric loan book, banks have been expanding their retail loan portfolios over the past few years. Retail loans accounted for 19% of system gross loans at the end of March 2020, up from 17% at the end of 2017. Credit card loans have been a key focus, driving retail loan growth. Credit card receivables as a share of consumer loans rose to 22% at the end of March 2020 from 16% at the end of 2017 (Exhibit 2). We expect the proposed interest rate cap to constrain the yield on credit card loans and potentially curtail the growth of Philippine banks' credit card business.

Exhibit 2

Share of credit card receivables has been increasing over the years from a low base



Source: Bangko Sentral ng Pilipinas

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P&C (re)insurers face losses from Hurricane Laura's landfall in southwestern Louisiana

On 27 August, Hurricane Laura struck southwestern Louisiana as a Category 4 storm, delivering heavy winds, storm surge and rainfall to the region and causing severe damage to residential and commercial properties, particularly around the city of Lake Charles. It will take time to determine the storm's full impact on the insurance industry, but property research firm CoreLogic estimates that insured losses will be in the range of $8-$12 billion. These losses will be borne by personal and commercial primary insurers, with portions ceded to reinsurers via occurrence-based and aggregate contracts. Some primary carriers are approaching their attachment points under aggregate reinsurance contracts based on catastrophe losses incurred year-to-date.

Exhibit 1 shows the top 10 homeowners insurers in Louisiana based on direct premiums written. State Farm Mutual Automobile Insurance Company (unrated), The Allstate Corporation (A3 stable) and USAA (Aa1 negative) have leading market shares in the state. Given their careful monitoring of exposures, geographic diversification, high-quality reinsurance protection and strong capital bases, we believe these large national carriers can withstand this event. Still, an outsized loss for any particular insurer or reinsurer might raise questions about its underwriting and risk management, and lead to a negative rating action. Regional insurers and state insurance funds face greater impact from the storm given their geographic concentrations.

Exhibit 1
Top 10 homeowners insurers in Louisiana, 2019

Company	LA Direct Premiums Written ($ Millions)	US Direct Premiums Written ($ Millions)	Premium Concentration in Louisiana	Surplus ($ Millions)
State Farm	504	18,978	2.7%	116,232
Allstate	213	8,723	2.4%	19,887
USAA	121	6,836	1.8%	30,476
Liberty Mutual	109	6,861	1.6%	20,539
Louisana Farm Bureau	93	93	100.0%	169
United	79	861	9.2%	416
Progressive	76	1,647	4.6%	13,670
Lighthouse	60	254	23.7%	55
FedNat	43	525	8.3%	142
Geovera Holdings, Inc.	36	211	16.9%	93
Total - Top 10	1,333	44,989	3.0%	201,678
Industry	1,965	108,831	1.8%	866,628

Note: Data reflect homeowners and farmowners lines
Source: SNL Financial L.C. (contains copyrighted and trade secret materials distributed under license from SNL, for recipient's internal use only) and Moody's Investors Service

We expect significant economic damage from the hurricane winds and related flooding. However, homeowners policies typically do not cover flood damage. Homeowners located in a flood zone often obtain coverage from the government-backed National Flood Insurance Program, a division of the Federal Emergency Management Agency (FEMA). In previous hurricanes, FEMA has provided some disaster assistance, including repair or replacement of homes for uninsured and underinsured homeowners. Flood damage often becomes a point of dispute when the immediate cause of loss (wind versus flood) is unclear. Commercial property insurers are more likely to incur losses from flooding, which is typically an optional commercial coverage.

Exhibit 2 shows the top 10 commercial property insurers in Louisiana based on direct premiums written, with CNA Financial Corporation (Baa2 stable), Liberty Mutual Group Inc. (Baa2 stable) and American International Group, Inc. (Baa1 stable) having the top market shares. Apart from property losses, commercial policies typically cover business interruption claims, which could be sizable to the extent the hurricane has damaged critical infrastructure, caused power outages or otherwise blocked access to covered properties.

Exhibit 2

Top 10 commercial property insurers in Louisiana, 2019

Company	LA Direct Premiums Written ($ Millions)	US Direct Premiums Written ($ Millions)	Premium Concentration in Louisiana	Surplus ($ Millions)
CNA	128	4,445	2.9%	10,787
Liberty Mutual	89	6,285	1.4%	20,539
AIG	77	3,731	2.1%	17,439
Zurich	76	2,555	3.0%	7,673
Factory Mutual	71	3,771	1.9%	13,708
State Farm	68	1,802	3.8%	116,232
Chubb	56	4,037	1.4%	17,646
Louisana Citizens	55	55	100.0%	186
Travelers	49	4,410	1.1%	20,670
Nationwide	44	2,892	1.5%	15,749
Total - Top 10	713	33,983	2.1%	240,629
Industry	1,660	84,111	2.0%	866,628

Note: Data reflect allied lines, commercial multiple peril non-liability, fire and inland marine lines; much of CNA's commercial property business pertains to a cellphone warranty fronting arrangement with minimal catastrophe risk

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

We expect that significant hurricane losses will be absorbed by Louisiana Citizens Property Insurance Corporation (LA Citizens). LA Citizens acts as a residual market mechanism for Louisiana residents and small businesses unable to procure property insurance through the voluntary market in homeowners and commercial property lines. As a residual market insurer, its risk exposures are concentrated in major cities and in the most hurricane exposed areas of the state. LA Citizens sustained large losses from Hurricanes Katrina and Rita in 2005 (approximately $1.1 billion net), which exhausted its existing claims-paying resources, requiring regular assessments on insurers operating in the state, as well as the issuance of $978 million in revenue bonds backed by future emergency assessments on Louisiana policyholders in subject lines of business.

LA Citizens currently has $560 million in total reinsurance and catastrophe bonds in place to pay storm losses. LA Citizens also has a $50 million line of credit with Regions Bank for additional liquidity. LA Citizens can impose regular assessments on insurers in the state for up to 10% of their written property premiums to help cover its deficits each calendar year. Based on present premium volumes, LA Citizens could collect a regular assessment of approximately $260 million within thirty days. In addition to the resources mentioned above, LA Citizens can levy an emergency assessment for up to 10% of written premiums on Louisiana property owners once a year to offset any debt incurred on storm losses. Based upon present state premium volumes, including premiums of LA Citizens, an emergency assessment of approximately $267 million could be collected each calendar year.

In addition to the homeowners and commercial property exposures highlighted here, insurers face potential environmental/pollution claims given that the storm caused severe damage to a chemical plant near Lake Charles. Environmental claims are notoriously complex and heavily litigated, although the underlying policies typically carry strict terms and dollar limits. Other potential sources of insurance claims include off-shore and on-shore energy facilities, personal and commercial watercraft, and personal and commercial automobiles.

With regard to business interruption claims, the coronavirus and related economic downturn might complicate coverage calculations and heighten the number of disputes. Some interruption claims might reflect a combination of hurricane and coronavirus effects, with coverages depending on a range of specific policy provisions.

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StepStone's IPO filing with the SEC is credit positive

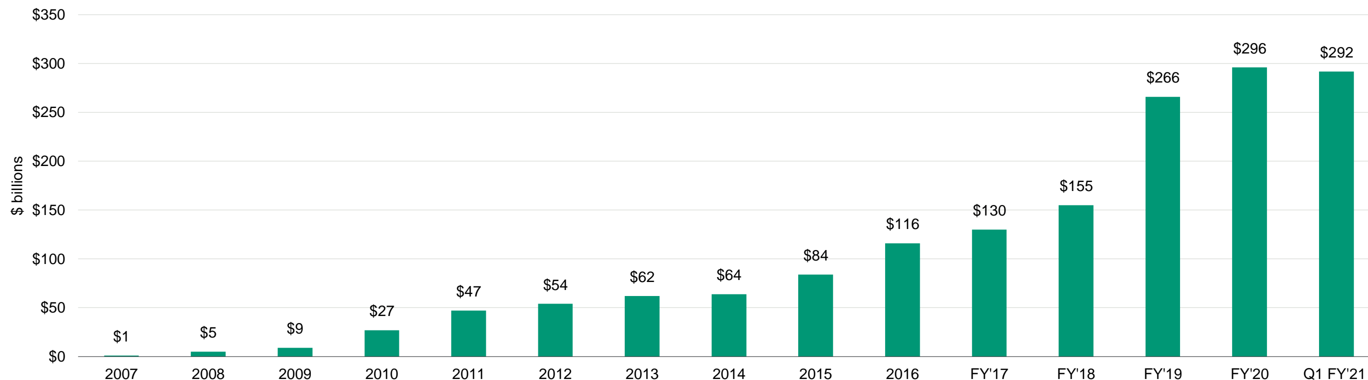
Originally published on 26 August 2020

On 24 August, StepStone Group Inc. (STEP) filed with the US Securities and Exchange Commission (SEC) a plan to raise equity capital via an initial public offering (IPO). STEP intends to use the net proceeds to purchase an ownership interest in StepStone Group LP (Ba3 stable), repay $143 million in borrowings under StepStone Group LP's existing term loan B, and use any remaining proceeds to fund growth and for other general corporate purposes. STEP is a Delaware corporation formed by StepStone Group LP for the purpose of completing the IPO and related transactions. Upon completion of the IPO process, STEP will be a public holding company.

The IPO will be credit positive for StepStone because the company's existing senior debt will be repaid well in advance of its March 2025 maturity. Furthermore, as a public company, financial disclosure will materially improve with the SEC's oversight and enforcement powers. In addition to enhanced financial disclosure, the company will publicly disclose a much greater amount of qualitative information on its strategy, future growth expectations and any competitive, legal or regulatory challenges. This information will be particularly helpful for creditors as will the real-time assessment of the company's financial condition and future prospects that are reflected in its stock price.

Founded in 2007, StepStone is a global private markets firm offering investors management and advisory services across private equity, private debt, infrastructure assets and real estate. StepStone's assets under management (AUM) and assets under advisement (AUA) totaled $292 billion at 30 June 2020, and have been growing rapidly since the firm's founding (see exhibit).

StepStone's total assets under management and assets under advisement
A 61% compound annual growth rate between 2007 and the first-quarter of fiscal 2021



The company's fiscal year ends 31 March.
Source: StepStone Group Inc. S-1

StepStone's planned IPO of common shares will account for a minority interest in the company. We expect that management and key employees will hold a majority stake and will retain a majority of the voting rights on all matters submitted to a vote of stockholders, including the election of directors and the approval of significant corporate transactions.

Although this disparity in voting rights is subject to a sunset clause, the value and liquidity of the company's common shares could be adversely affected at the time of and after the IPO. For example, certain index providers, such as S&P Dow Jones, exclude companies with multiple share classes from being added to certain stock indices. In addition, several stockholder advisory firms and large institutional investors oppose the use of multiple share class structures. Depending on market conditions, this risks limiting the IPO proceeds available to pay down debt and invest in future growth.

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Germany's extension of short-time work scheme will create labour market inefficiencies, a credit negative

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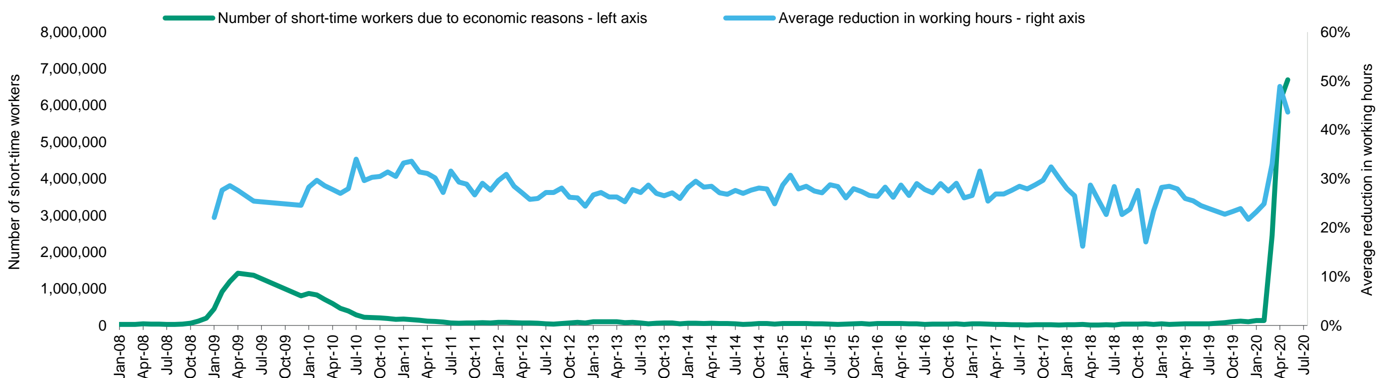
On 25 August, the Government of Germany (Aaa stable) announced the extension of its short-term work scheme (*Kurzarbeit*) to up to 24 months from 12 months. The job-retention scheme allows employees to work shorter hours, with the government topping up their wages. The government also announced the extension of temporary regulations that facilitate access to the scheme, reducing the costs for companies and ensuring higher compensation for participating employees.[1]

Although the scheme's extension supports domestic demand, it is overall credit negative for Germany, because its extended use will lead to additional fiscal costs and will create labour market inefficiencies and impede structural change. The latter will weigh on medium-term growth. The inefficiencies arise from the impediment of the reallocation of labour from contracting sectors to expanding sectors of the economy, preserving jobs that would otherwise not be viable.

The scheme's extension will increase its fiscal costs beyond 2020. However, we expect additional fiscal costs to be below the costs of short-time work in 2020 because of a decreasing number of overall short-time workers. According to estimates by the German Federal Employment Agency, the scheme will cost around €20 billion in 2020, or 0.6% of GDP, of which the agency has already paid out €14.2 billion. The additional costs in 2021 are expected to be significantly lower.

While the short-time work scheme has supported economic activity and prevented a surge in unemployment (which has increased by only 0.9 percentage points to 4.2% in June since the beginning of the year), this masks the actual underutilisation of labour. The number of short-time workers is likely to have peaked in May at 6.7 million, or around 20% of total employment subject to social security contributions (see exhibit). However, short-time work is expected to remain significant in sectors most affected by the coronavirus crisis, such as travel and tourism.

Use of short-time work has increased to all-time highs
Number of short-time workers (left), average reduction in working hours (%, right)



Sources: German Federal Employment Agency and Moody's Investors Service

Short-time work schemes aim to help companies and workers weather downturns or temporary shocks. As such, it is ideally suited to deal with sharp but ultimately short-lived shocks such as that sparked by the coronavirus pandemic.[2] Following a deep recession in the first half of 2020, we expect Germany's economy to begin to recover in the third quarter and forecast GDP growth of 5.4% in 2021 following a 6.7% contraction this year. Overall, prolonging the scheme now increases the adverse side effects of the arrangement, including fiscal costs and the creation of labour market inefficiencies.

Endnotes

1 See Government of Germany – Aaa stable: Update following forecast changes, 28 April 2020.

2 See Job retention schemes in Europe mitigate economic damage of coronavirus shock, 21 July 2020.

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Japan's prime minister resigns, adding uncertainty about achieving Abenomics' goals

Originally published on 29 August 2020

On 28 August, Japanese Prime Minister Shinzo Abe said he would resign after the ruling Liberal Democratic Party elects a new president, who will then take over as prime minister. Abe's resignation leaves the mission of his administration's so-called Abenomics program incomplete. As coronavirus-related economic effects threaten to erode the gains from previous Abenomics' reforms, the impending leadership transition adds uncertainty to the government's commitment to achieve the program's key goals or achieve them within previously targeted time frames.

Since Abe regained leadership in December 2012, the Abenomics approach sought to reflate the economy through aggressive monetary policy, flexible fiscal policy and structural reform. Each of these three "arrows" corresponded to specific targets, such as an annual headline inflation rate of 2%. Other commitments include achieving a primary fiscal balance (excluding debt interest payments) by fiscal 2025 (ending March 2026), which was changed from fiscal 2020 and which follows an intermediate primary fiscal deficit target of 1% of GDP in fiscal 2018; and steadily reducing public debt as a share of GDP beyond fiscal 2020. Abe in 2015 also pledged structural reforms to raise nominal GDP to ¥600 trillion ($5.5 trillion) by fiscal 2020 from just over ¥500 trillion.

Headline CPI inflation averaged only 0.3% year on year over the first seven months of 2020, after 1.0% and 0.5% in 2018 and 2019 respectively. Decelerating inflation reflects the pandemic shock's overwhelming effect on domestic demand, which more than offset upward pressure on prices from the consumption tax hike implemented in October 2019.

Combined with lower revenue because of the faltering economy, the large countercyclical fiscal packages announced earlier this year all but eliminate prospects for the government to meet its primary surplus target. We expect that the general government deficit for fiscal 2020 will widen to levels last seen at the outset of the Abe administration, wiping out gains made in fiscal consolidation through expenditure restraint and higher revenue, aided by higher consumption tax rates; the shortfall had narrowed to 2.2% of GDP in fiscal 2018 from more than 10% in fiscal 2009. Moreover, we expect general government debt to rise sharply to 230% of GDP this fiscal year from 200%-205% in fiscal 2014-18.

Three consecutive quarters of real GDP contraction, culminating in a 7.8% decline in the April-June quarter of this year, distanced nominal GDP from the ¥600 trillion target. Fiscal 2019 nominal GDP was ¥552.4 trillion, only 6.6% higher than ¥518.2 trillion in fiscal 2014. Nevertheless, labor market reforms have driven underlying improvements in employment and labor force participation, mitigating the negative pressure on potential growth from population aging.

While the pandemic persists, the government will likely prioritize management of the public health crisis and its effect on the economy before turning its policy focus back to structural reform and fiscal sustainability.

The track record on economic reflation over the past eight years, while mixed, was facilitated by the political stability of Abe's strong hold on the premiership, a departure from the succession of ineffective prime ministers and weak policy outcomes from 2007-12. Although it is uncertain whether the next prime minister can consolidate political support to the same extent as Abe, the abrupt announcement hastens a transition that would have given his successor a more solid mandate for the continued pursuit of economic reform.

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Extended note rollover is credit positive for New York's local governments and school districts

Originally published on 28 August 2020

On 24 August, New York (Aa1 negative) Governor Andrew Cuomo signed legislation extending local governments' and school districts' rollover period for bond anticipation notes issued between 2015 and 2021. The extension, to seven years from five, will provide much-needed near-term relief for local governments and school districts dealing with revenue losses caused by the coronavirus pandemic.

The extended rollover period will give local governments a number of options. For those facing significant budgetary strain, management will be able to delay the issuance of long-term debt for at least two more years, providing some budgetary relief this year and next. For governments in a better financial position, the ability to roll over the notes an extra two years will allow management to shift the expected long-term interest costs to either reducing the note's principal or cash funding of capital. In either case, long-term principal would decline, lowering future interest payments.

New York local governments, particularly school districts, are very active issuers of bond anticipation notes. Nonetheless, with interest rates at all-time lows, taking advantage of the long-term market in the current environment may offset the benefits of rolling over notes for two additional years.

In addition to extending the rollover period, the legislation provides two other forms of short-term budgetary relief. First, the period in which governments must replenish restricted funds that they transfer temporarily to their operating budgets has been extended to five years in equal annual installments from the previous requirement to replenish them within the current fiscal year. This is particularly helpful for local governments whose fiscal years end in December, because the pandemic is having a much larger financial effect on them than those, such as school districts or villages, that have midyear fiscal year ends. The ability to transfer restricted funds to the operating budget and not have to begin repayment until 2021 will allow local governments to deal with revenue losses this year and focus on repayment next year. The only downside is that any funds transferred will need to be paid back with interest.

Second, the legislation will ease local governments' access to capital reserve funds to pay for capital costs attributable to the pandemic. Governments will no longer need a referendum to move the funds, allowing them instant access. Capital reserve funds would normally be locked up and not available for coronavirus-related expenses.

Additionally,, the legislation will help New York governments weather the adverse budgetary effect of lower state aid. Income tax and sales tax losses caused by the pandemic have hit the state's budget hard. As a result, New York has been withholding 20% of state aid typically distributed to local governments, a reduction that will likely become permanent without any federal assistance. For school districts, which do not start receiving the bulk of their state aid until closer to the end of the year, the withholding has so far had no effect on budgets. But many other local governments, especially those with fiscal year ends in December, are already dealing with the effects of the 20% withholding. Many local governments such as counties and towns, also have high exposure to sales tax. That exposure, coupled with state aid withholding, only adds to revenue losses.

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Tourism tax plunge increases Illinois' debt service burden for Chicago convention center

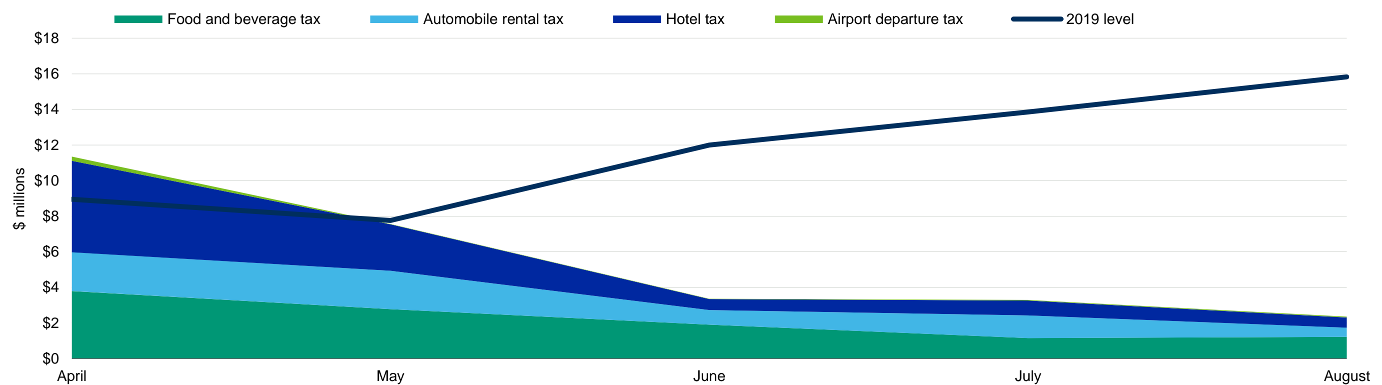
On 25 August, Chicago's Metropolitan Pier and Exposition Authority (Met Pier), which owns and operates the largest US convention center, reported that hotel, restaurant and other tax revenue pledged to its bonds (Ba1 negative) fell 85% in August compared to a year earlier. The COVID-19-related revenue loss is credit negative for the State of Illinois (Baa3 negative), because state sales tax revenue covers debt service (up to $300 million) when Met Pier's pledged tax revenue falls short. Diversion of sales tax will intensify stress on the state's finances and widen its budget deficit.

Met Pier's approximately $2.9 billion of bonds are secured by Chicago-area tourism taxes and, as a backstop, by state sales tax revenue. Reduced air travel and restrictions including Illinois Governor JB Pritzker's 20 March statewide stay-at-home order, which is no longer in effect, have curtailed hotel stays and restaurant meals in the City of Chicago (Ba1 stable), which account for most of Met Pier's tax revenue.[1] In early July, the city pegged the economic cost of canceled conventions and similar events at $900 million.

Met Pier's weak August tax revenue marks another in a series of declines that began in April. Monthly collections for June through August were 78% below year-earlier levels on average (see exhibit). Met Pier's convention center, McCormick Place, has suffered from a wave of cancellations because of the pandemic.[2]

Exhibit 1

Met Pier's revenue sources that secure its bonds have plummeted as a result of the coronavirus



Because Met Pier tax revenues are received and reported with a lag, monthly collections in exhibit reflect earlier activity. August numbers are preliminary.
Source: Metropolitan Pier and Exposition Authority

Reduced tourism and convention activity hurts Chicago's economy, but the city benefits from industrial and revenue diversity. Its largest employment sector encompasses professional and business services, information and financial activities. As in other US cities, the pandemic caused Chicago's unemployment to surge, with the tourism-driven leisure and hospitality sectors among the hardest hit. A recovery in tourism nationally to pre-pandemic volume is unlikely before 2023. Recovery of business travel, including for conventions, will take longest.

For the state, the immediate burden of helping pay Met Pier's debt service — which it does automatically each month when the tourism tax revenue falls short — is relatively small. Met Pier debt service in fiscal 2022 (ending 30 June 2022) is $260 million, about 8.8% of state general obligation (GO) bond debt service that year.[3]

In addition, Met Pier's maximum annual debt service totals only 4.5% of the state's fiscal 2020 sales tax revenue, following a 2.4% decline in the year ended June 30. If state sales tax collections fall much more sharply in the year that started July 1, for a total 12% loss in the two years, available sales tax revenue would still provide more than 19 times coverage of maximum annual debt service. The

state allocates sales tax revenue to Met Pier bonds under a statute that is amended to accommodate actual Met Pier debt service. The current schedule authorizes $300 million per year through fiscal 2026, and the amount rises to $450 million 10 years later.

To counter lost tourism taxes, Met Pier can also refinance debt. In March, it issued $882 million of refunding bonds, including a portion to capitalize fiscal 2020 and 2021 interest. A pending $163 million issue includes additional refunding components and $46.3 million to cover fiscal 2021 and 2022 operating expenses.

Endnotes

1 The state is now in "Phase 4" of reopening, which allows operation of businesses such as bars, restaurants and retail stores, subject to capacity limits.

2 The authority has reported cancellations by organizers of 149 events scheduled through 30 June 2021, at McCormick Place and several other venues it operates. The authority had projected $167 million from these events.

3 Met Pier's debt service includes the effect of $163 million of Met Pier bonds (primarily for refunding purposes) likely to be priced in coming weeks. This $260 million of debt service compares with our estimate for the state's fiscal 2022 GO debt service — almost $3 billion, which excludes repayment of the state's potential three-year borrowing from the Federal Reserve's Municipal Liquidity Facility which may be incurred later this calendar year.

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Podcasts and Videos

Focus on Finance - Podcast: Coronavirus turns up heat on European insurers and India's public-sector banks, 26 August 2020

Antonello Aquino from the Insurance team explains why European insurers are giving back premiums now and might have to cover more claims later because of the pandemic (begins at 1:59). Plus, Banking team analyst Alka Anbarasu details the government support India's public-sector banks will need to maintain capital strength as credit costs rise in COVID-19's wake (begins at 9:09).

Related reports: *Financial Institutions - Public Sector Banks - India: Coronavirus fallout will leave banks with capital shortages again* and *Financial Institutions - Non-life Insurance – Europe: Insurers face increasing social and legal risks arising from coronavirus*

Podcast: After COVID, leisure travel will recover before business travel, 25 August 2020

Earl Heffintrayer of the Project Infrastructure and Finance team, Valentina Gomez of the US Public Finance team and Peter Trombetta of the Corporates team discuss how leisure travel will lead the way for travel and tourism-dependent sectors' recovery after COVID-19. Long-haul, international and business travel will lag the return to pre-coronavirus levels.

Related report: *Cross-Sector - Coronavirus - Global: Consumer comfort vital for travel, tourism- dependent sectors' eventual recovery*

Podcast: Oil and gas sectors will not spring back quickly with pandemic's end, 25 August 2020

Steve Wood and Elena Nadtotchi from the Corporates team discuss the future of the oil and gas industry in the wake of the COVID-19 pandemic.

Related report: *Corporates - Oil & Gas - Global: COVID sparks shift across industry toward lower growth and consolidation*

Podcast: Global retail faces mounting pressures from pandemic, 24 August 2020

Christina Boni and David Beadle of the Corporates team discuss how US and European retailers are responding to big changes and coping with an accelerated shift of consumers online.

Related report: *Corporates - Retail - Global: Pandemic is forcing retail to accelerate its transformation*

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Editors

Jay Sherman, Elisa Herr, Andrew Bullard, Julian Halliburton and Phil Macdonald

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