Credit Outlook

14 September 2020

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KAR's BacklotCars acquisition reduces liquidity but will complement its digital strategy

Originally published on 10 September 2020

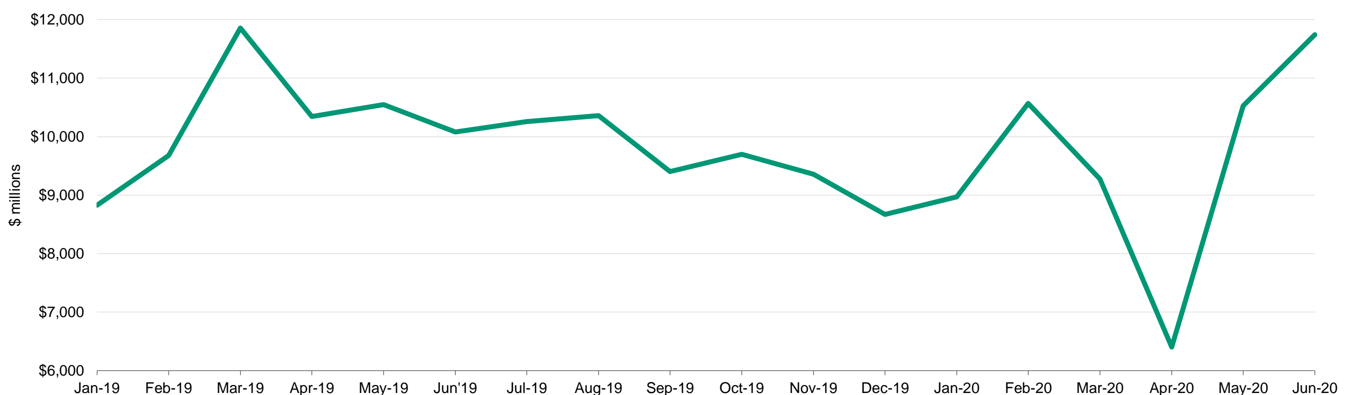
On 8 September, KAR Auction Services Inc. (B2 negative) announced the $425 million acquisition of BacklotCars Inc, a digital provider of dealer-to-dealer auctions. KAR expects the transaction to close before year-end and to finance it with cash on hand. The new asset will complement KAR's capabilities in the digital dealer-to-dealer wholesale segment and will incorporate new local markets.[1].

KAR's operations were severely affected at the onset of the coronavirus outbreak as social distancing restrictions in March and April 2020 forced to shut down most physical auction locations. Auction volumes decreased materially, putting pressure on the company's liquidity while supply and demand trends were disrupted by the pandemic. In the second-quarter, KAR raised approximately $550 million of cash through the issuance of convertible preferred shares, a credit positive development to support liquidity in the event of a prolonged period of depressed volumes.

The proposed $425 million acquisition reduces liquidity at a time when the effect and duration of COVID-19 remains uncertain. However, better-than-anticipated volume in the second half of the second quarter, driven by strong demand for used cars and KAR's ability to transition to digital channels, mitigate liquidity concerns.

Second-quarter operating cash flow rebounded from negative levels in the first quarter, boosted by growing volumes and working capital dynamics. A few factors have contributed to improving volumes since the April trough: government stimulus (CARES act), favorable financing terms with historically low interest rates, and increasing demand for private transportation options that reduce the risk of COVID-19 contagion (versus public transportation alternatives) have fueled consumer demand for used cars. Used car retail sales have rebounded to pre-pandemic levels (see exhibit) after the April trough. However, the recessionary environment caused by the coronavirus pandemic elevates risks because volumes could remain volatile given the uncertainty around contagion rates, further government stimuli and availability of favorable consumer financing.

Retail used car sales



Source: Federal Reserve Bank of St. Louis

BacklotCars aligns with KAR's strategic transition to digital channels, but we anticipate the acquisition will be dilutive to operating margins. Similar to TradeRev, we expect BacklotCars will require incremental scale to improve profitability, despite the potential operating benefits of combining the two dealer to dealer assets. Overall, the digital acceleration triggered by COVID-19 should improve

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KAR's long-term profitability. KAR furloughed 11,000 employees in April 2020 and has only called back 5,000. The company has notified 3,000 workers that their positions are no longer required. KAR's transition to a fully digital model reduces physical labor costs and creates efficiencies. COVID-19 has forced KAR's customer base to embrace online channels, drastically reducing the digital adoption timeline.

Although many dealers have sought out digital auctions out of necessity, the new behavior is likely to become permanent, even after the health emergency recedes. The speed, availability and overall efficiency of online channels will support a permanent transition. We expect leverage to remain above 6x over the next 12 months (Moody's-adjusted including securitization debt and operating leases), as improving margins are offset by lower revenue, which will be affected by volatile volumes and lower revenue per unit.

KAR Auction Services, Inc. is a leading provider of vehicle auction services in North America. The company provides used car auction services through its wholly-owned subsidiary, ADESA, Inc. and short-term financing to independent dealers through its wholly-owned subsidiary, Automotive Finance Corporation. KAR provides wholesale marketplaces where sellers and buyers transact, and also facilitates ancillary services to market participants such as transportation, reconditioning and other services. KAR generated $2.4 billion in revenue as of the last twelve months ending June 2020.

Endnotes

1 KAR entered the dealer to dealer market with the 50% acquisition of TradeRev in 2014, and acquired the remaining 50% in 2017

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Aveanna Healthcare's term loan add-on and tuck-in acquisitions are credit negative

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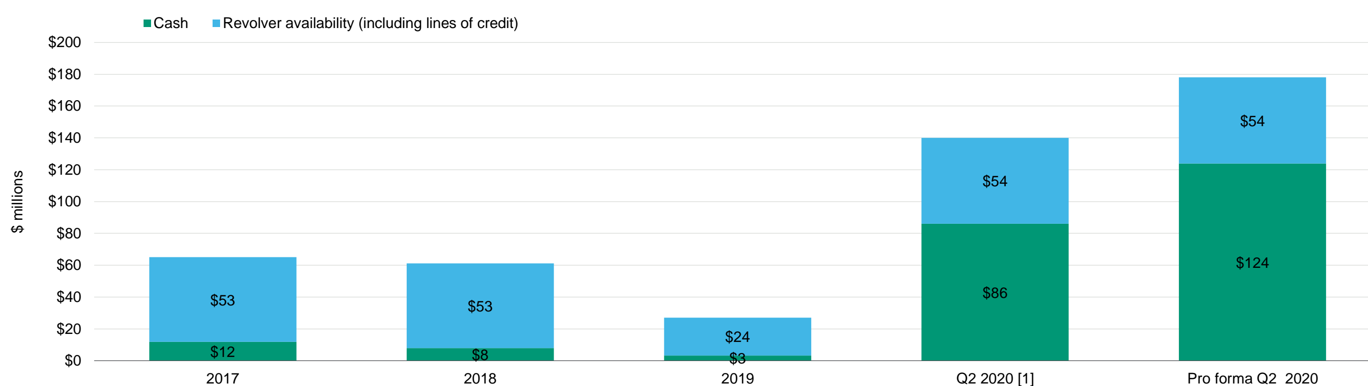
On 10 September, Aveanna Healthcare LLC (B3 negative) announced a $185 million add-on to its existing senior secured first lien term loan. Proceeds will be used to fund four tuck-in acquisitions, as well as add cash to the balance sheet. The increase in overall debt and interest is credit negative because it will slow Aveanna's deleveraging.

The added debt will increase Aveanna's pro forma debt/EBITDA to 8.0x for the 12 months to 30 June, up from 7.5x for the same period prior to the transaction. Annual interest expense will increase by $13.5 million, to roughly $100 million, annually. Further, the four tuck-in acquisitions suggest that Aveanna is increasing its pace of M&A activity again, after having paused following the termination of acquisition of Maxim Health Services, Inc.'s home care service division in December 2019, which would have been transformative. Aveanna is also broadening the scope of its acquisitions, as one of its tuck-ins is a provider of adult home health and hospice services, representing a foray into a new business for Aveanna. However, Aveanna's B3 Corporate Family Rating, the B2 ratings on its senior secured first lien credit facilities, and the Caa2 ratings on the company's second lien debt are not affected.

Mitigating the increase in leverage, Aveanna's liquidity will improve with approximately $51 million of proceeds from the term loan add-on allocated to the balance sheet (see exhibit). Following the transaction, Aveanna will have approximately $124 million of cash, as well as access to roughly $54 million of its $75 million revolving facility as of 30 June 2020. The company's liquidity benefitted from good cash management in recent months, including solid cash collections, cost reductions, and benefit from the The Coronavirus Aid, Relief and Economic Security (CARES) Act provisions.

Aveanna's liquidity will be strengthened by an additional $51 million of cash



[1] The second-quarter 2020 cash balance includes $12 million, which was subsequently utilized on 2 August 2020 to fund Total Care, Inc., one of the four acquisitions referenced above.
Sources: The company and Moody's Investors Service estimates

While the company's cash will be significant at close, we expect the majority of it to be utilized over the next 12 months for additional tuck-in acquisitions, similar to the four that are being funded by the term loan add-on.

Headquartered in Atlanta, Aveanna was formed through the merger of pediatric home healthcare companies Epic Health Services and PSA Healthcare, with a subsequent acquisition of Premier Healthcare Services completed in July 2018. The company is a leading provider of pediatric skilled nursing and therapy services, as well as adult home health services, including skilled nursing, therapy, personal care, behavioral health and autism. Aveanna is majority-owned by private equity firms Bain Capital and J. H. Whitney. The company generated pro forma revenue of approximately $1.5 billion for the 12 months that ended 30 June 2020.

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Increased US oversight for authorising new tobacco products is credit positive

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On 9 September, the US Food and Drugs Administration (FDA) deadline for manufacturers of certain new tobacco products to submit their premarket tobacco applications (PMTA) will end. Although traditional cigarettes are grandfathered and need not go through the PMTA process,[1] after 9 September no new tobacco product can be sold in the US without the FDA's authorisation and existing products may be removed from the market if the premarket applications were not submitted on time.

The PMTA deadline is credit positive for the four large rated tobacco companies operating in the US - Altria Group Inc. (A3 stable), British American Tobacco Plc (BAT, Baa2 stable), Imperial Brands PLC (Imperial, Baa3 stable) and Philip Morris International Inc. (PMI, A2 stable).[2] The regulation will reduce the number of competitors in the US market for vaping and heat-not-burn tobacco products because some smaller competitors were unable to meet the deadline. Also, FDA-authorized new tobacco products will have lower (but still significant) regulatory risk than in the past.

BAT's US subsidiary, Reynolds American Inc. (Baa2), submitted PMTAs for its main VUSE (vaping) and VELO (modern oral) brands, making it likely that the company will be allowed to continue selling them in the US, potentially with new products or products previously banned coming back to the market. BAT sells only vapour and modern oral products (tobacco pouches and other oral products containing nicotine) in the US, but no heated tobacco.[3]

Imperial submitted its PMTAs in April for a wide range of its "myblu" branded products and also submitted PMTAs for other US vaping products in its portfolio, including key products from the blu plus range and its disposable range.[4] Although Imperial may see some of the banned products be allowed back into the US market, its revenue base will likely remain low over the next 12-18 months. Plans for future submissions after the PMTA deadline will be subject to the outcome of an ongoing strategic review.

PMI is one of the only two tobacco companies (the other being Swedish Match AB (Baa2 stable) whose smokeless products were granted the FDA's first-ever modified risk orders in October 2019 and authorised to sell a version of its Platform 1 product (IQOS) under the PMTA pathway in April 2019. These products were also granted "modified risk status" in July 2020 and are much closer than any others to have reduced regulatory risks.

Although PMI just started the commercialisation of its heat-not-burn products in the US in September 2019 through an agreement with Altria, the success of its IQOS brand products in Japan and other regions suggests that its sales potential in the US is substantial.[5] We believe the company has no near- term plan for FDA applications for its vaping products.

Altria has no meaningful direct exposure to the new tobacco product categories, but paid $12.8 billion for a 35% stake in JUUL in December 2018. Since then, Altria has written down approximately 67% of the investment after the removal of JUUL's flavoured e-vapor products from the market and e-vapor consumer-related lawsuits.

Regulatory risks in the US will begin to substantially decline only when products receive modified risk status and scientific evidence is available about their effects on consumer health and when the proportion of net revenue generated from reduced-risk categories increases over 20% towards 50%.

Endnotes

1 PMTA is required for new tobacco products that were not commercially marketed in the US as of 15 February 2007.

2 Altria's split from PMI in 2008 but it has an agreement with Altria to commercialise its IQOS heat-not-burn products in the US.

3 On a constant currency basis, in 1H 2020, BAT generated £166 million of revenue from vaping products (out of total vaping revenues of £265 million globally) up 70% year on year and £77 million from modern oral products, up 71% year on year. Its share of the US market in the two categories was around 26% and 9%, respectively, both up strongly year on year.

4 US vaping product revenue (plus Canada) was £30 million in fiscal first-half 2020, which ended 31 March, down 51% versus fiscal first-half 2019. Revenue from the US and Canada of £30 million represented 36% of total New Generation Products revenues of £83 million.

5 PMI's reduced-risk products platform IQOS generated $5.6 billion net revenue in 2019, or 18.7% of total net revenue. PMI aims to grow its reduced-risk product net revenue to 38%-42% of total net revenue by 2025.

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Philip Morris' narrowed earnings guidance and new product launches will reduce leverage and social risks

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On 10 September, Philip Morris International Inc. (PMI, A2 stable) narrowed its guidance for full-year adjusted earnings to $5.00-5.07 per share from $4.92-5.07 previously because it expects a stronger-than-anticipated financial performance in the third quarter of 2020, ending 30 September. The company also announced that it had expanded its potentially reduced-risk products portfolio by launching its vaping products in New Zealand.

The new product launches and narrowed earnings guidance are credit positive for PMI because they will increase its proportion of net revenue from potentially reduced-risk products, reducing social risks and improving key debt metrics over the next 12-18 months, in our opinion.

PMI's leverage, as measured by Moody's-adjusted debt to EBITDA, increased to 2.9x in the second quarter of 2020 from 2.7x in the first quarter, remaining above the 2.5x threshold required to maintain its A2 rating. We expect leverage to remain between 2.5x and 3.0x in 2020 and fall below 2.5x only in 2021, but the revised earnings and new product launches will accelerate the expected improvement.

The company expanded its product platform following the launch of IQOS VEEV, a closed vaping system, in New Zealand recently.[1] New Zealand is the first country in which PMI has launched its vaping products and additional rollouts are planned over in Q4 2020. The company also launched its first KT&G-licensed[2] smoke-free products in Russia in the last few months[3]; the products will complement PMI's heat-not-burn products, which it sells in Russia and the Ukraine, and will likely launch in other countries in the near future.

PMI generated around $1.6 billion net revenue overall (including combustibles) in Eastern Europe, including Russia, in the first half of 2020, and said that its IQOS HEETS share of the Russian market had risen 3 percentage points to 5.9% year-over-year.[4]

The company stated that the market share for its heated tobacco units (excluding the US) increased 1.8 percentage points compared to Q2 2019 to 6.3% in the second quarter of 2020. The company's reduced-risk products platform, IQOS, generated $5.6 billion of net revenue in 2019, or 18.7% of total net revenue, well ahead of all rated peers and growing. PMI aims to grow its potentially reduced-risk product net revenue to 38%-42% of total net revenue by 2025.

To date, PMI has generated its reduced-risk revenue almost exclusively from heat-not-burn products, and the launch of IQOS VEEV is a major new step in developing and diversifying this portfolio. Other tobacco manufacturers have established a presence in vaping markets over the past several years and PMI will be playing catch-up in these markets, albeit with a potentially better product and benefiting from the established IQOS brand and a commercialisation infrastructure already in place.

The revised earnings guidance reflects better-than-anticipated industry trends in the EU, the Philippines and Turkey, and higher pricing in Japan, as well as certain inventory movement timing benefits that are apt to reverse in the fourth quarter of this year. Nevertheless, PMI reiterated that challenges relating to the effects of the coronavirus pandemic will remain significant until year end, particularly in Indonesia and in the duty-free segment.

Endnotes

1 IQOS VEEV is the latest generation of vaping product in PMI's portfolio and a closed system whose heating technology allows the heater to remain in constant contact with the e-liquid, thus delivering taste consistency, unlike wick and coil e-cigarettes, according to PMI.

2 PMI announced in January an agreement with KT&G, a South Korean tobacco and nicotine company, to commercialise KT&G's smoke-free products outside South Korea.

3 The first launch of KT&G licensed smoke-free products was announced in August.

4 While PMI's heated tobacco shipments rose by 7.7% to 9,076 million units in Q2 2020 compared to Q2 2019 in East Asia & Australia, growth in Europe was particularly strong in Q2 2020 compared to Q2 2019, up 38.9% to 4,227 million units in the EU and up 82.6% to 5,126 million units in Eastern Europe. Shipments to the UK, where vaping products are widely consumed, increased fivefold.

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Wm Morrison's profits will grow despite price cuts, a credit positive

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On 10 September, Wm Morrison Supermarkets Plc (Baa2 stable), the UK's fourth-largest grocer by market share, announced in its fiscal 2021 first-half (ended 2 August 2020) results that it expects its profits will continue to grow despite ongoing price cuts and the temporary adverse effect of coronavirus.

The guidance signals that Morrisons can lower prices without eating into its margins and will likely gain market share in the UK grocers' ongoing price war. Earlier in the week, Morrisons announced on 7 September that it would cut prices on more than 400 items by an average 23%.

Morrisons' Moody's-adjusted EBITDA margin has been stable for the past five years. It was 5.4% at first-half fiscal 2021, down from 5.6% at fiscal 2020 year end (2 February) and fiscal 2019.

We estimate Morrisons' Moody's-adjusted gross debt was £3.0 billion and EBITDA was £943 million in the 12 months to 2 August, resulting in leverage of 3.2x, up from 2.8x at fiscal 2020 year end, driven by rising net costs related to the coronavirus pandemic. While the company said it expects profits will grow in fiscal 2021 despite the price cuts, it refrained from clear guidance for the full year. Although leverage of 3.2x is slightly above our 2.0x-3.0x guidance for Morrisons' Baa2 rating, in our base case, we expect EBITDA margins to remain broadly stable over the next 12-18 months and leverage to improve back below 3x, but at the high end of the range.

In its 7 September announcement, the company said it will cut and hold down the price of over 400 of the most popular items by an average of 23% and that it has already cut the price of over 800 popular products. The company made it clear that these price cuts are permanent. The move is driven by expectations of weaker consumer spending and increased online demand in the UK and a price war among grocers. In June, Tesco PLC (Baa3 stable), the UK's largest grocer, extended its campaign to match prices of German discounter Aldi, Asda's "pocket tap" adverts and a new "Price Lock" campaign from Sainsbury's. UK grocers are also competing for market share by increasing their online delivery capabilities because of ongoing changes in shopping habits.

Morrisons expects profits to more than offset the price cuts by negotiating lower prices with some of the large consumer goods companies, and to gain market share without further eroding its debt metrics. The company should also have other levers to offset price cuts: additional sales will come from supplying 240 McColl's stores in the second half of fiscal 2021 and from an expanded agreement with Amazon.com Inc. (A2 positive). We understand that the profitability of online deliveries remains low even on a fully loaded basis, which may negatively affect margins if these operations continue to grow from the current level of around 10% of retail sales. The price reductions announced, increased Amazon sales (at lower margin) and increased online (also lower margin) sales will put further pressure on margins, in our opinion. Morrisons' share of the UK grocery market was 10.2% as of 9 August 2020, according to Kantarworldpanel, an industry consultant, broadly unchanged year on year.

On a reported basis, profit before tax and exceptionals was £148 million, down 25.3% year on year, driven by higher net operating costs due to the pandemic of £62 million (£155 million costs partly offset by £93 million lower business rates) and despite 8.7% higher like-for-like sales (ex-fuel/ex-VAT). Indeed, the higher sales reflected a mix weighted toward online channels and lower margin categories, and were therefore less profitable than usual. Also, fuel sales fell sharply and cafés were temporarily closed.

Liquidity remains solid despite temporarily negative free cash flow driven by working capital outflows related to fuel sales. At the end of the first half of fiscal 2021, Morrisons had increased its total revolving credit facilities to £1.75 billion from £1.45 billion at the end of fiscal 2020, of which £1.35 billion mature in 2025 and four £100 million facilities run for a year with two having options to be extended by six months. At the end of the first half, £1.3 billion of these facilities remained undrawn.

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Reliance's stake sale in retail segment will allow growth while maintaining zero net debt, a credit positive

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On 9 September, Reliance Industries Limited (RIL, Baa2 negative) announced the divestment of 1.75% stake in its retail arm to private equity firm Silver Lake Partners for INR75 billion ($1 billion). The transaction is credit positive as it will enable RIL to continue to pursue other growth opportunities while maintaining zero net debt.

The deal is the company's first divestment within the retail segment, which is currently wholly owned by RIL. With this deal, the Indian conglomerate has now established an enterprise value for its retail segment, which sets the stage for further stake sales within the segment (see Exhibit 1).

Exhibit 1
Established enterprise value for major business segments will facilitate further sales
Business segment enterprise values

Refers to major business segments only
Source: Company

As part of the transaction, Silver Lake will acquire a 1.75% stake in Reliance Retail Ventures Limited (RRVL), a fully owned subsidiary of RIL. The transaction remains subject to various regulatory and shareholder approvals and is likely to close over the next few months.

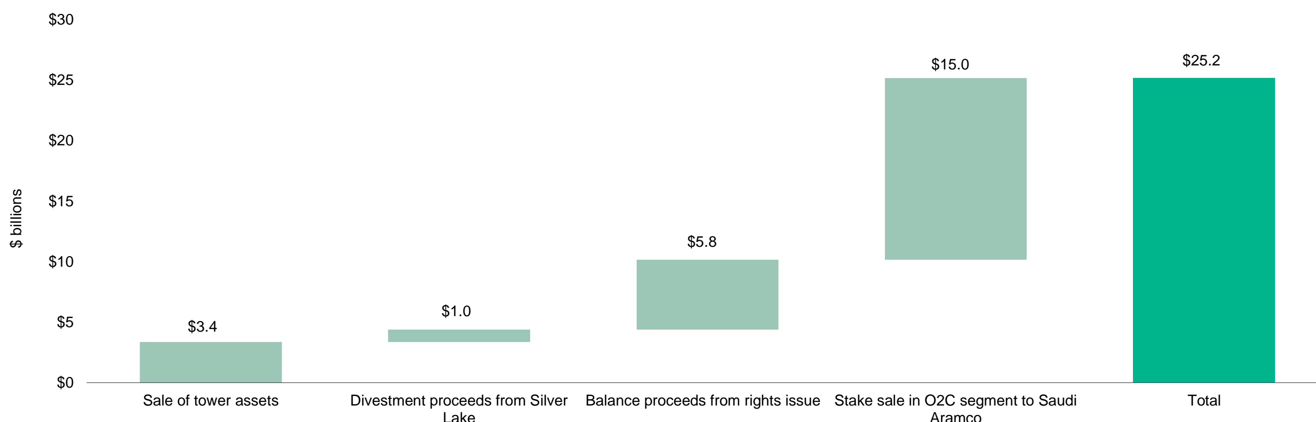
The proposed divestment will help to further the company's ambitions within the retail segment without straining its balance sheet. Although RIL's capital spending will drop compared with historical levels, the company will continue to incur large capital spending across all business segments for its next stage of growth. However, we expect the bulk of this growth to be financed by proceeds from asset sales, which will enable the company to continue with its strategy of maintaining zero net debt.

With RIL's digital services business having achieved a critical mass and strong market position in India, we expect that it will now focus on growing its retail segment. The company is already the industry leader within the organized retail sector in India, but the contribution from this segment to consolidated EBITDA remains low at around 10%. Further growth in the segment will augment RIL's overall earnings base and lead to improved earnings diversification. RIL's 29 August announcement of its acquisition of the consumer businesses of Future Group is a step toward growing its retail business and expanding its retail footprint.

Including the current transaction and based on RIL's previous announcements, we expect the company to raise around $25 billion from further stake sales across various business segments and balance proceeds from a rights issue offering in the next 12-18 months (see Exhibit 2). With zero net debt, all proceeds from future asset sales can be used for growth initiatives.

Exhibit 2

RIL can potentially generate an additional $25 billion from announced stake sales and balance proceeds from its rights issue offering



Sources: Company and Moody's Investors Service estimates

Notwithstanding the company's strategy of pursuing growth while maintaining financial discipline, a rating upgrade is unlikely unless the Government of India (Baa3 negative) is upgraded to Baa2. This is because the company's increased linkages with the domestic economy constrain its rating to no more than one notch above the Indian sovereign rating.

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Saka Energi Indonesia's operations are weak ahead of January loan maturity

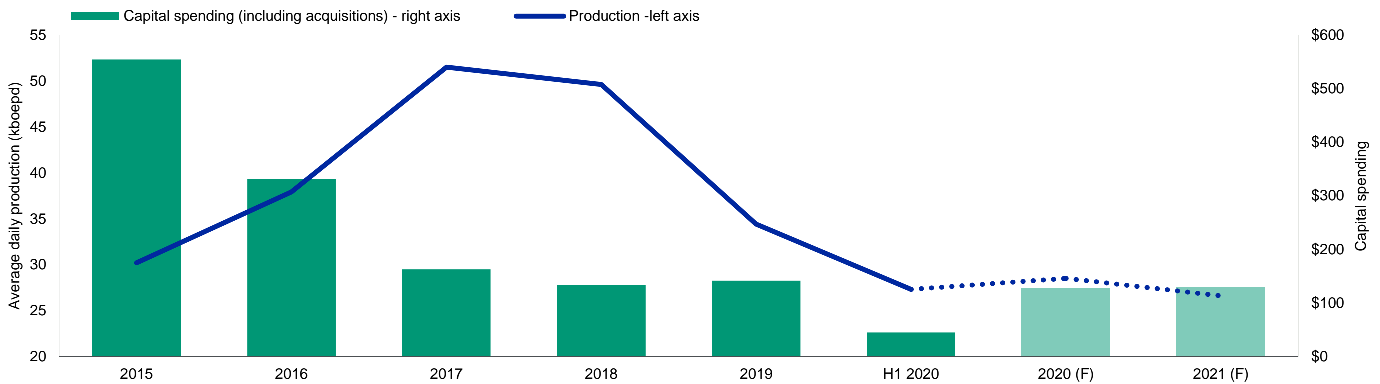
Originally published on 10 September 2020

On 8 September, Saka Energi Indonesia (P.T.) (B1 negative) announced weak operating and financial results for first half 2020. Average daily production fell by 27% year on year to 27.3 thousand barrels of oil equivalent per day (kboepd) in first half 2020 because of weak market demand and a decline in production. The lower volumes, combined with weak oil and gas prices, drove a 52% year-on-year decline in Saka's adjusted EBITDA to around $60 million.

The weak first-half results are credit negative and reflect Saka's deterioration in operations following around four years of low investment and its vulnerability to volatile commodity prices. Saka's liquidity is also strained from a $155.2 million loan owed to its sole shareholder, Perusahaan Gas Negara (P.T.) (PGN, Baa2 stable), which will mature in January 2021. According to Saka, PGN said in late August that it intends to extend the shareholder loan by two years.

Saka cut capital spending by $20 million year on year to $45 million in the first half of 2020. While this will help it conserve liquidity in 2020, we expect the company's production levels will continue to fall because of low investment (see Exhibit 1).

Exhibit 1
Operations will remain weak in the absence of significant investments

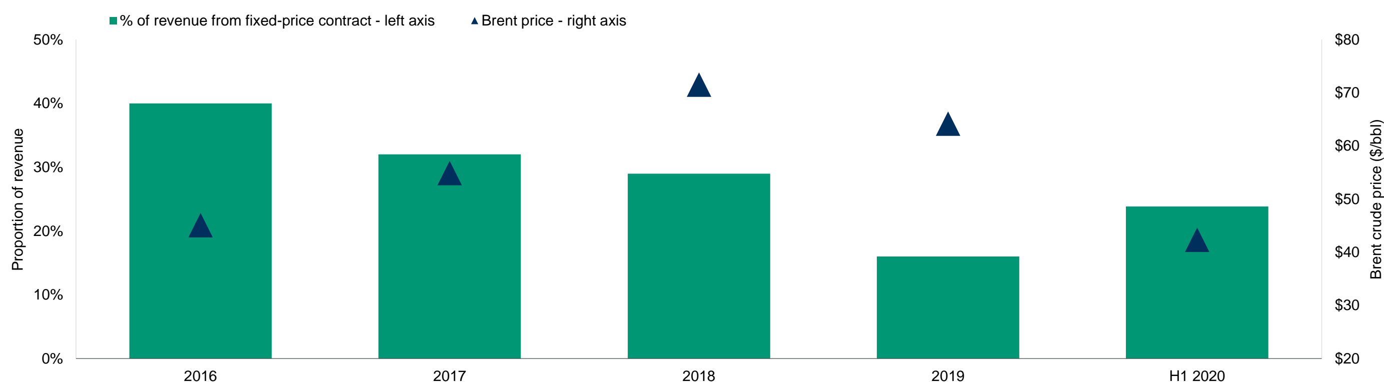


Sources: Company, Moody's Financial Metrics™ and Moody's Investors Service estimates

Additionally, Saka's earnings are more exposed to fluctuations in oil and gas prices following the expiration of its production licenses at Sanga Sanga and Southeast Sumatera in third quarter 2018. This is reflected in the decline in the proportion of revenue generated from fixed-price contracts in 2019 from 2018 despite lower crude prices (see Exhibit 2).

Exhibit 2

Proportion of revenue generated from fixed-price contracts fell in 2019 after expiration of several production licenses



Sources: Company and Bloomberg

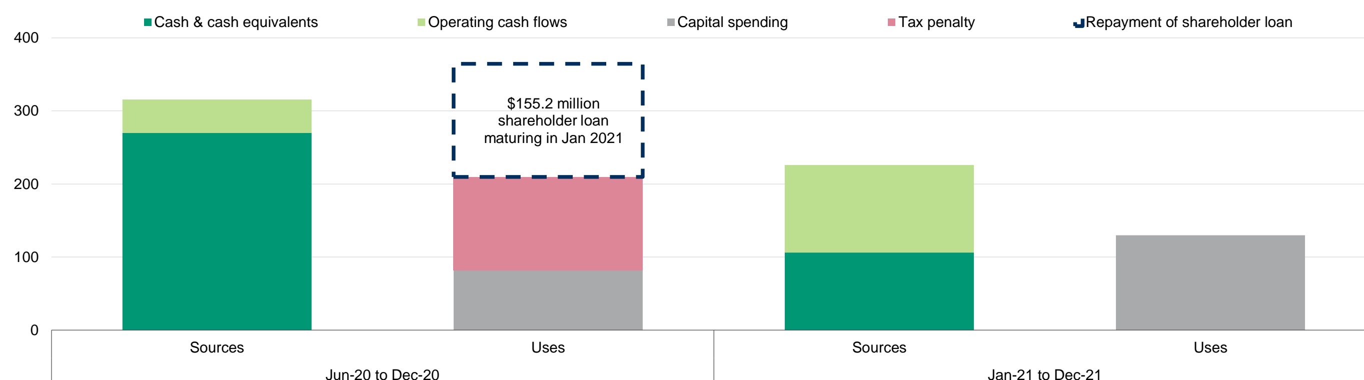
Under our Brent price assumptions of $40 per barrel in 2020 and $45 per barrel in 2021, we expect Saka's leverage, as measured by adjusted debt/EBITDA, will increase to around 9.0x in 2020 from 4.3x in 2019, before recovering slightly to 7.5x in 2021. Without the conversion of its $438 million shareholder loan into equity, the company is unlikely to reduce its leverage substantially. Interest coverage, measured by adjusted EBITDA/interest, will also weaken to 2.5x-3.0x in 2021 from 4.3x in 2019. Nevertheless, we expect that the company's interest coverage ratio will remain above our downgrade guidance of 2.5x.

Cash and short-term investments held by Saka fell to $270.2 million as at 30 June 2020 from $351.4 million in 2019 following the company's $140.3 million payment to the tax authorities in April 2020. Most of the payment is related to a tax penalty that the Indonesian Supreme Court in January 2020 held Saka liable to pay for. A further $127.7 million of tax liability that Saka needs to pay is still under discussion with the tax authorities. Our projections have assumed that the potential tax penalty will be paid in the second half of 2020.

Saka's liquidity will be inadequate (see Exhibit 3) if it has to pay both the potential tax penalty and the shareholder loan maturing in January 2021. We expect that Saka will secure the extension of the shareholder loan, which is reflected in the two notches of rating uplift from parental support currently incorporated in Saka's B1 rating. Negative rating pressure will increase if the extension of the shareholder loan is not confirmed by end of October 2020.

Exhibit 3

Saka's liquidity will be inadequate by January 2021 if it has to pay the potential tax penalty and maturing shareholder loan



Source: Moody's Investors Service estimates

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MassMutual’s planned sale of group retirement business to Great-West unit is credit positive

Originally published on 08 September 2020

On 8 September, Massachusetts Mutual Life Insurance Company (insurance financial strength Aa3 stable) and Empower announced their definitive agreement for MassMutual’s sale of its group retirement plan business to Empower, the retirement and asset administration unit of Great-West LIfe & Annuity Insurance Co. (insurance financial strength Aa3 stable), the US subsidiary of Canada-based Great-West Lifeco (Great-West Life Assurance Company insurance financial strength Aa3 stable).

The sale is credit positive for MassMutual because sale proceeds will enhance its regulatory capital and the sale will free capital to focus on the company's core participating whole life insurance and asset management businesses. As of second quarter 2020, MassMutual was a top seller of participating whole life insurance, a product we consider to be at the highest end of the credit spectrum.

According to the agreement, MassMutual’s retirement business, which includes defined benefit and defined contribution plans, will be sold via a reinsurance transaction for a ceding commission of $2.35 billion in cash, and will free up $1 billion of required capital MassMutual had held to support the business.

The proceeds and the freed-up capital will strengthen MassMutual's NAIC Risk-Based Capital (RBC) ratio, which was 440% at year-end 2019. Although a 440% ratio is strong, it is lower than in prior years and a higher buffer is particularly beneficial given the adverse effects of the higher mortality rate and economic fallout from the coronavirus on MassMutual.

MassMutual launched its retirement business about 75 years ago. Even with approximately $175 billion of assets under management (AUM) and administration, the business did not have sufficient scale to compete in an environment of ever-rising technology investment to support the retirement business, and ever-decreasing fees. Empower is the second-largest player in the US and will have $834 billion AUM pro forma for the MassMutual retirement business acquisition.

Despite credit-positive effects, MassMutual will lose the revenue and business diversification benefits from the low-risk, capital-light retirement business, and its balance sheet will shrink appreciably. The company will be challenged to find other sources of earnings at the same level of risk.

Redeploying the proceeds to strengthen and grow its core US life insurance business would be credit positive. However, redeploying the funds in higher-risk businesses and/or investments, such as its leveraged loan joint venture Jeffries Finance LLC (Ba3 stable), would be credit negative. Similar to other mutual life insurers, MassMutual uses a portion of earnings from its other businesses and investments to support its participating life dividend to help support agent sales efforts. Therefore, the need to replace lost earnings quickly from its retirement business will be acute.

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Great West Life acquires MassMutual's retirement business, a credit positive for its US record-keeping business

Originally published on 09 September 2020

On 8 September, Great-West Lifeco Inc. (GWO)[1], a Canadian life insurance and asset management group, announced its definitive agreement to acquire, through its Empower brand, the retirement services business of Massachusetts Mutual Life Insurance Company (MassMutual, insurance financial strength Aa3 stable) in a reinsurance transaction for ceding commission of $2.35 billion.

The transaction is credit positive for GWO's US Empower operation, potentially generating incremental fee-based returns in the highly competitive, crowded retirement and asset administration market (see exhibit). The acquisition will strengthen Empower's number two position the asset administration and record-keeping market, giving it total pro forma assets under administration of $834 billion as of 30 June 2020. The business is also capital light, and typically interest insensitive, which is a plus in the current ultra-low interest rate environment.

Empower is a leading retirement services provider in a crowded field

Company	Total 401(k) assets
Fidelity Investments	$2,037,733
Empower Retirement	$493,577
The Vanguard Group, Inc.	$454,223
Tempo Acquisition (Alight Solutions)	$434,737
Principal Financial Group	$322,976
Voya Financial	$221,389
T. Rowe Price	$195,224
Prudential Retirement	$180,544
Bank of America Corp	$173,412
Charles Schwab	$162,876
Total	**$4,676,691**

Total 401(k) asset amounts are in thousands. Empower is the brand name of the Great-West Life and Annuity Ins. Company
Sources: PLANSPONSOR Recordkeeping Survey 2019 and Moody's Investors Service

Under the terms of the agreement, Empower will receive MassMutual's retirement services business comprising 26,000 plans with 2.5 million participants and $167 billion in client assets.

GWO expects the acquisition, slated to close in the fourth quarter of this year, to be accretive to consolidated earnings starting in 2021, with $160 million of annual run-rate synergies to be phased in over the next 18 months. After 2022, GWO expects earnings accretion of 10% and expects the entire US segment to contribute 20% of overall GWO earnings. It also expects revenue synergies with MassMutual, although these are typically less certain and take longer to achieve.

The largely debt-financed acquisition closely follows the company's June 2020 agreement to acquire hybrid robo/registered investment advisor, Personal Capital for $825 million plus an earn out. GWO will raise approximately $1.5 billion of new long-term debt in addition to $500 million of short-term financing, with the residual of the $2.35 billion coming from existing cash.

We estimate pro forma financial leverage of 33.5%, up from 25.8% at year-end 2019, and pro forma operating leverage of 37.2% versus 30.0% at year-end 2019, both high compared with similarly rated peers. GWO, the level at which we assess leverage for the operating companies, has historically lagged its peers because of acquisition debt. Until this transaction and recent fund raising, the company had the lowest leverage metrics among the large Canadian life insurers at year-end 2019. Leverage will increase from this transaction and recent debt issuance in May and July, as well as the completion of the partially debt-funded acquisition of Personal Capital. Still, GWO has a history of reducing leverage after funding opportunistic acquisitions and we expect a return to more sustainable leverage metrics within 18 months of the acquisition's close.

Execution risk is also significant, particularly during a pandemic. In addition, high unemployment in the US as a fallout from the coronavirus may throw off some of Canada Life's assumptions about plan and participant persistency, lowering returns on the business over the next several years versus its expectations.

Endnotes

1 GWO is the parent of Great-West Life & Annuity Insurance Company (GWLA, insurance financial strength Aa3 stable) and its subsidiary Great-West Life & Annuity Insurance Company of New York (GWLA NY, insurance financial strength Aa3 stable)

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Mexico proposes lower 2021 federal transfers to regional and state governments, a credit negative

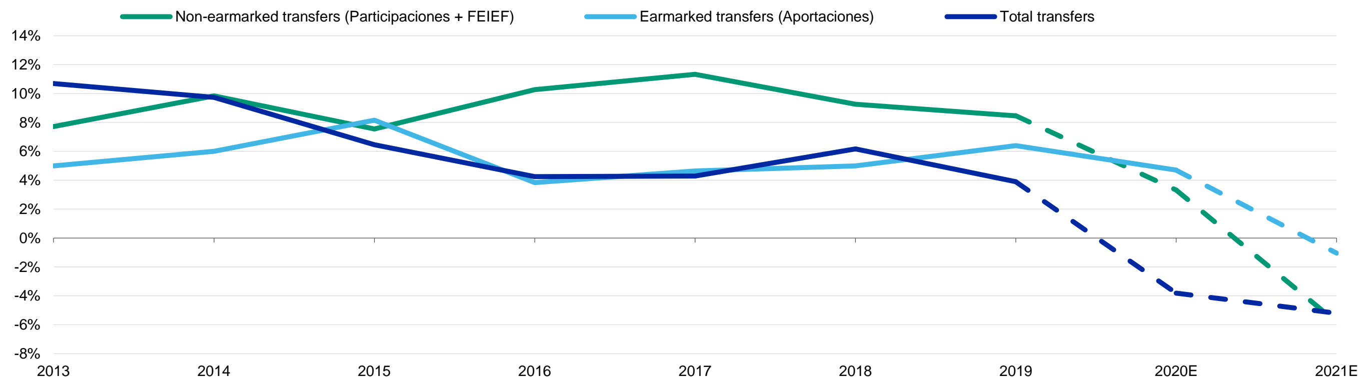
On 8 September, Mexico's (Baa1 negative) federal government published a draft 2021 budget that includes cuts in federal transfers to regional and local governments (RLGs). Lower earmarked and non-earmarked federal transfers in 2021 will exacerbate pressure from RLGs' own-source revenue declines this year and will require both operating and capital spending cuts at the state and municipal level.

For many RLGs, 2021 is an election year, and declining transfers in 2021 will likely result in deficits and continued liquidity weakness, compounding challenges as changes in administration create uncertainty about policy continuity. Total federal transfers account for an average of 82% of operating revenue for Moody's-rated Mexican states, and 67% on average for rated municipalities.

In the proposed 2021 budget, which congress will review in the coming months, the government projects a 1.2% cut to states and municipalities' earmarked federal transfers (*aportaciones*), which are used primarily to fund social programs and designated infrastructure projects. Aportaciones have historically had a steady average 5% growth rate: the proposed cut would be the first reduction in such transfers in more than a decade. Non-earmarked transfers (*participaciones*), which are funded with federal tax collections and oil revenue and can be used to cover operating expenditures, would decline nearly 6% in nominal terms versus 2020. Other special transfers (*convenios*), which are used to fund capital projects, would decline 25%. Convenios have been reduced significantly in recent years and are therefore budgeted to remain at very low levels in 2021. We estimate total federal transfers, including both earmarked and non-earmarked transfers, will decline 5.2% next year (see Exhibit 1).

Exhibit 1

Following years of steady growth, transfers will decline in 2021



Total transfers include convenios.

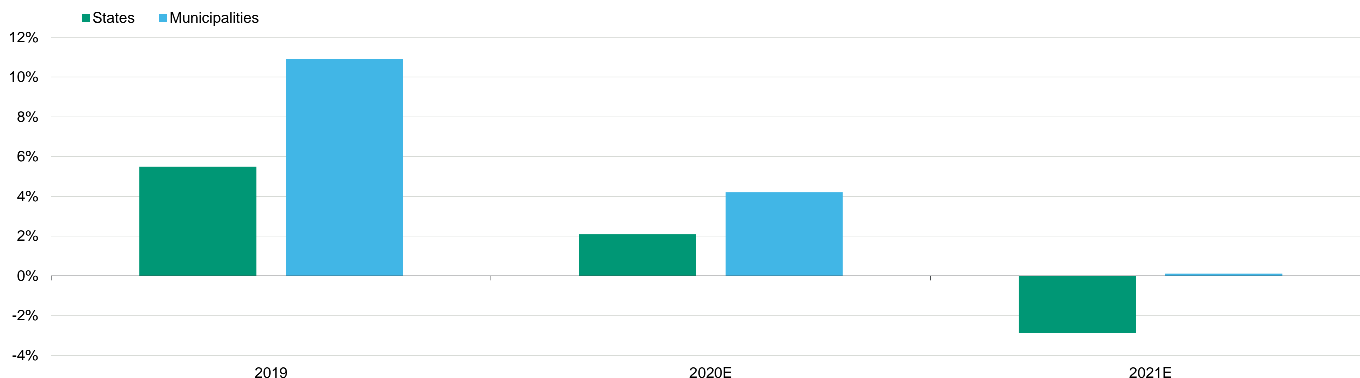
Sources: Mexico's Ministry of Finance and Moody's Investors Service

If the draft budget is approved without changes to increase transfers, we project states will report gross operating deficits that average 2.9% of operating revenue in 2021 (assuming spending growth remains in line with historical trends), compared with a projected average 2.1% gross operating surplus in 2020 (see Exhibit 2). Operating results for municipalities will also weaken in 2021, but less than for states given that transfers comprise a smaller share of their revenue (67% for municipalities versus 82% for states).

Exhibit 2

Continued revenue pressure will likely result in deficits next year

Average gross operating balance/operating revenue (%)



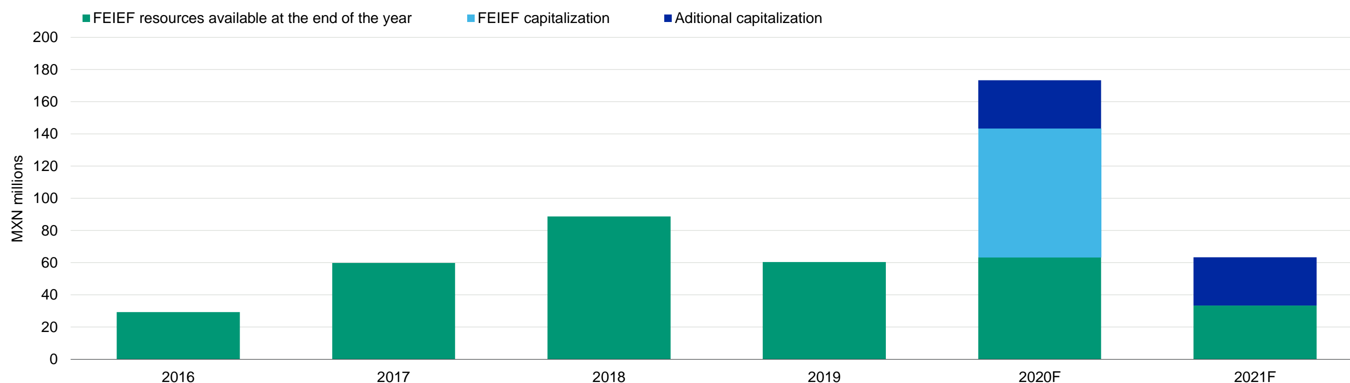
Sources: Mexican states' financial statements and Moody's Investors Service

Unlike some optimistic assumptions in the government's proposed 2021 budget – for example, 4.6% GDP growth, which is above our 3.7% 2021 GDP forecast -- projected transfers are relatively conservative, whereas in prior years the federal government projected stronger growth in transfers. The lower transfer projections reduce the likelihood that RLGs in 2021 will need to draw on resources from the Fondo de Estabilización para los Ingresos de las Entidades Federativas (FEIEF), a contingency fund designed to cover shortfalls between budgeted and actual participaciones.

Activation of the FEIEF this year is cushioning RLGs' operating results and softening what would otherwise be a sharp drop in transfers amid the recession. Without resources from FEIEF this year, we estimate that our projected 10% contraction in Mexico's 2020 GDP wouldlead to a 7.1% drop in participaciones. Activation of the contingency fund, which was topped up this year through a capitalization, will allow participaciones to instead grow 3.3% this year (see Exhibit 3).

Exhibit 3

Conservative budgeting will allow the FEIEF to maintain a modest cushion in 2021



Additional capitalization refers to a second round of financing which will only be tapped as deemed necessary.
Sources: Mexico's Ministry of Finance and Moody's Investors Service

We cannot rule out a downside scenario in which a weaker-than-expected economic recovery next year reduces tax revenue and results in another shortfall in participaciones. However, the federal government's more conservative budget forecasts for transfers should leave the FEIEF untouched, which will provide a modest cushion to guard against future shocks in the sector.

Nonetheless, lower transfers and deficits will continue exert pressure on RLGs' already generally weak liquidity and will further contribute to a buildup of infrastructure needs as capital spending remains a low levels.

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City of Buenos Aires' share of federal tax revenue will shrink, but Province of Buenos Aires will benefit

Originally published on 11 September 2020

On 10 September, Argentina (Ca negative) President Alberto Fernandez reduced the percentage of tax revenue the federal government shares with the City of Buenos Aires (Caa3 negative). The abrupt central government policy change allows it to allocate the tax revenue to the Province of Buenos Aires (Ca negative), which faces acute liquidity needs.

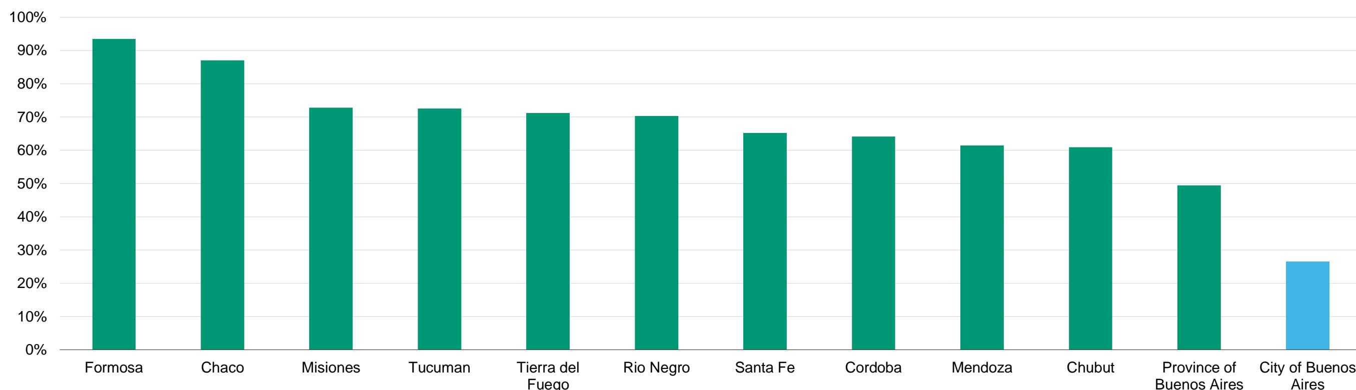
The reduction is credit negative for the city, which will receive 2.32% of federal tax revenue under the new regime, effective immediately, down from the 3.5% annually since 2017. The reduction and central government policy change are also credit negative for regional governments' operating environment while provincial budgets are strained because of the coronavirus pandemic. The sovereign's any further erratic credit-negative policymaking and intervention in regional government finances will likely hurt those provinces that entered the pandemic facing the largest operational deficits in 2019, such as the Province of Chubut (Ca negative) and the Province of Rio Negro (Ca negative).

However, the change is positive for the Province of Buenos Aires, which will benefit from the revenue stream. The tax revenue not going to the city will finance a fund to assist the province with its severe liquidity constraints, increasing its share of the federal taxes to around 23% from around 21% annually since 2017. The fund is not earmarked for salary expenses, but the measure was implemented in response to protesters demanding increased salaries for the provincial police force.

The Province of Buenos Aires is currently cash-strapped and unable to cover its operating expenses because of the increased expenses and a severe pandemic-related reduction in tax collection. Between January and August 2020 the Province's own-source tax revenue grew 24.3% versus the same period in 2019, slower than the 12-month inflation rate of 42.0% as of July creating a meaningful decrease in real terms. The inability to cover operating expenses prompted the province to issue on 8 September, ARS15 billion in notes to contractors and suppliers to pay off overdue accounts payable. The social unrest and acute liquidity needs come as the province is restructuring $7.1 billion of its foreign-currency notes because of its difficult financial position.

Although the City of Buenos Aires is less dependent on the federal tax-sharing regime than other Argentine provinces (see exhibit) and its credit profile is stronger than those of local peers', the measure increases the vulnerability of Argentine sub-sovereigns' credit to the federal government, which has a long history of haphazard policymaking, and a highly contentious political process. In the near term, any further abrupt policy changes that hurt sub- sovereigns' finances would most hurt those provinces currently in negotiations with bondholders for debt relief, such as the Province of Mendoza (Ca negative), the Province of Rio Negro, the Province of Chaco (Ca negative), the Province of Chubut and the Province of Cordoba (Ca negative).

The City of Buenos Aires is less dependent on the federal tax-sharing regime than other provinces
Federal transfers from the federal tax regime to regional governments' operating expenses as of 2019



Source: Economy Ministry

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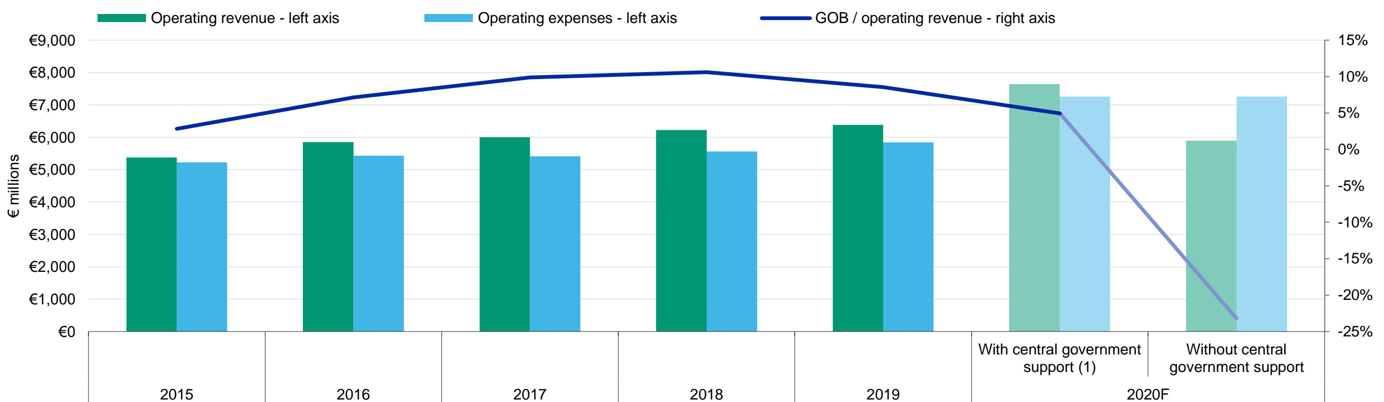
Ile-de-France Mobilites will benefit from additional government support

On 8 September, Valérie Pécresse, President of Ile-de-France Mobilites (IdFM, Aa2 negative), said the Government of France (Aa2 stable) will extend a reimbursable cash advance to IdFM of €1.1-€1.4 billion to help the public transit provider recover from fare revenue losses because of the coronavirus pandemic. The interest-free grant, which will be paid to IdFM as an operating subsidy, is repayable from 2023 over 16 years.

The grant is credit positive for IdFM, which organizes and coordinates public transportation in the Ile-de-France region, because it mitigates the pandemic's effect on its operating revenue and allows its gross operating balance (GOB) to remain positive in 2020 (see Exhibit 1). It also reflects government support for IdFM, which in September received a €425 million operating subsidy from the government amid sharply reduced demand for travel because of the pandemic. The government is committed to adjusting its support in 2021 to offset the effects of the crisis based on ex-post estimates of the 2020 losses.

Exhibit 1

IdFM's GOB ratio would have been negative in 2020 without central government support

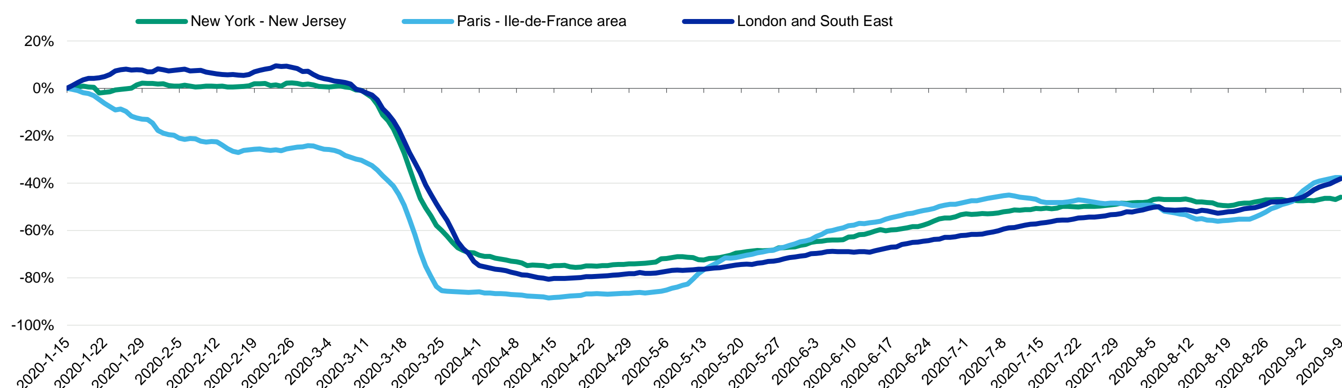


Sources: IdFM and Moody's Investors Service

A government-commissioned impact study at the end of July estimated IdFM's gross loss due to coronavirus at €2.1 billion in 2020 (33% of 2019 operating revenue). Fare losses represent two thirds of IdFM's gross loss for the period (or €1.4 billion). The pandemic and government measures to contain it sharply reduced demand for travel in the Ile-de-France area, as it did in other major metropolitan areas such as London and New York (see Exhibit 2). The unprecedented decrease in passengers revenue and the potential permanent effects on demand for IdFM's services are a challenge for the funding model of public transportation in the Ile-de-France region.

Exhibit 2

Public transport use in the Paris region is still running well below pre-crisis levels



Sources: Moovit and Moody's Investors Service

The government's €425 million operating subsidy (6.7% of 2019 operating revenue) narrowed IdFM's coronavirus-related mobility-tax revenue losses. The mobility tax has each year contributed on average 70.8% of IdFM's operating revenue over the past five years. While all local governments responsible for public transportation have benefitted from central government support to mitigate mobility-tax losses, the €1.1-€1.4 billion grant to IdFM (17.2%-21.9% of 2019 operating revenue) is the only one earmarked to cover revenue loss from fewer fares.

At the core of France's highly centralised transportation network, Paris and the Ile-de-France area retain a central role nationally and in Europe. The Ile-de-France region's GDP contributes 30.5% to national GDP and 4.6% to the European Union's GDP, according to 2018 data, higher than Greater London (UK, 3.6%) or Lombardy (Italy, 2.4%). With 12.2 million inhabitants, Ile-de-France also has 19% of France's metropolitan population. With 10 million daily users, IdFM, as the public transport provider in the capital region, plays a key role in the national economy, which is captured in our assessment of a high likelihood of extraordinary support from the government. IdFM is also a key shareholder contributing to France's 2050 goal of lowering greenhouse gas emissions.

The government's grant is also credit positive for mass transit and rail operators RATP (Aa2 negative) and SNCF S.A. (Aa3 stable) because IdFM mandates and compensates them to operate the Ile-de-France area's (including the city of Paris) public transport network based on multiyear contracts. The grant allows IdFM to compensate the two state-owned operators in fiscal year 2020.

Although the grant is repayable to the government from 2023, a detailed repayment schedule has yet to be published. We expect the government to ask for repayment only if economic conditions and IdFM's financials (including tax and fare revenue) permit.

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Improved tax forecasts reduce budget pressure on Germany's regional and local governments in 2020

Originally published on 11 September 2020

On 10 September, Germany's (Aaa stable) Federal Ministry of Finance published revised 2020 estimates for the tax revenue of each level of government showing a 5.5% decline in the tax revenue of regional governments (Länder) compared with 2019 and a 9.8% decline in the tax revenue of local governments (communes). The declines are lower than previous estimates of 8.4% and 11.1%, respectively, and reflect the federal government's expectation that GDP growth will contract by 5.8% this year compared with the previously estimated 6.3%.

The tax revenue shortfalls are negative in themselves, however, the fact that tax revenue realisation in the second quarter of the year, which included the strict lockdown period, was better than expected, and that the projected decline in full-year revenue is lower than initially forecast, is positive. The latest estimates also point to a slower than expected recovery in 2021, when the federal government projects that regional governments' tax revenue will increase by only 5.0% compared with 11.1% previously, and that of the communes by 9.1% (13.0%). These estimates are still 1% below 2019 levels, with tax revenue only forecast to exceed pre-crisis levels in 2022.

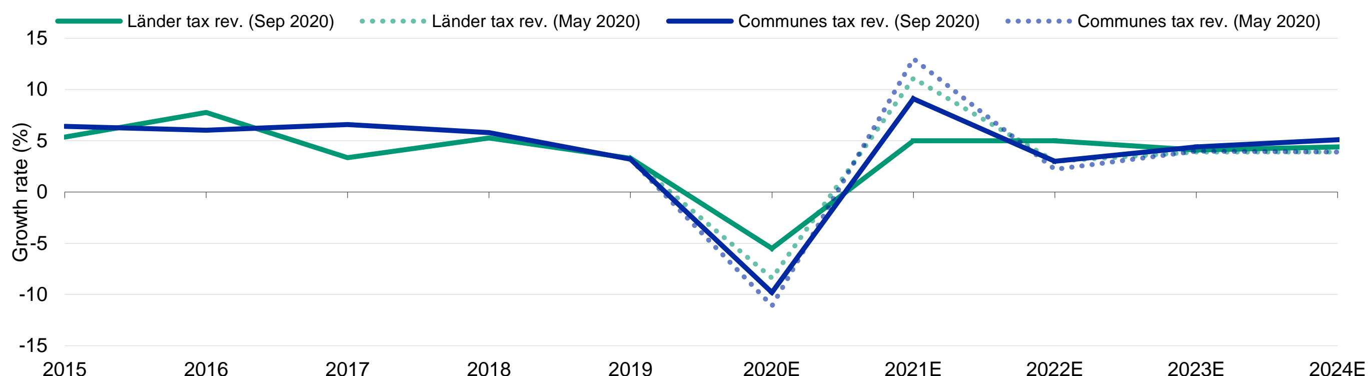
Data for realised tax revenue in the first half of 2020 now include the impact of the lockdown triggered by the coronavirus pandemic, which in Germany was most stringent between March and May. Regional governments' tax revenue fell by 6.7% year-over-year to €148.8 billion, equal to 49% of their forecast tax revenue for 2020. However, the decrease is forecast to be less in the second half of this year compared with the same period in 2019, as the second quarter essentially accounted for all of the first-half decrease. Communes' share in the joint taxes that make up 45% of their revenue fell by 3.4% year-over-year, and currently attain a 56% fulfillment of the estimated amount for full-year 2020.

While the economy has gradually reopened, enabling tax revenue to slowly recover, we expect Germany's GDP to contract by 6.7% in 2020. On top of support measures for regional and local economies, the tax revenue shortfall will drive financing deficits in 2020, resulting in new borrowing made possible by the invoking of the emergency situation clause in the federal and Länder debt brake at the end of March. The Ministry of Finance currently expects the exemption from the debt brake to remain in effect in 2021. Heightened pressure on regional and local governments has in most cases translated in budget adjustments and plans for substantial new borrowing to implement countercyclical policies.

Tax revenue declines and the cost of support measures will temporarily increase debt levels but we expect the low interest rate environment to persist in 2020, contributing to sustained debt affordability. We view the temporary weakening of German regional and local governments' financial performance as manageable. Federal government and Länder support counterbalances the communes' tax revenue shortfall.

According to the estimated recovery trajectory, tax revenue growth rates in 2021 – 5.0% for the Länder and 9.1% for the communes – (see exhibit) will only partly compensate for the decline in 2020, pushing up collected taxes to slightly below 2019 levels (-1%) and only exceeding it in 2022. Annual tax revenue growth for regional and local governments between 2022 and 2024 is projected to be 4.4% on average, higher than the previously forecast 3.6%, reflecting that the forecast tax revenue trajectory will only reach the previous estimate in 2024.

The coronavirus pandemic has significantly weakened German regional and local governments' tax revenue growth this year



Growth rates from 2020 onward are estimates

Sources: German regional and local governments, German Ministry of Finance and Moody's Investors Service

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CREDIT IN DEPTH

Stable wealth-management arms of largest Swiss and US banks are a credit positive offset to COVID-19 disruption

Originally published on 10 September 2020

The macroeconomic, commercial and financial disruptions accompanying the coronavirus (COVID-19) outbreak have cast a cloud over the prospects of wealth management (WM) activities[1], including those of the five largest Swiss and US-based global investment banks that have significant wealth management activities, namely Bank of America Corporation (A2 stable[2]), Credit Suisse Group AG (Baa2 positive), JPMorgan Chase & Co. (A2 stable), Morgan Stanley (A3 review for upgrade) and UBS Group AG (A3 stable[3]). However, we expect that worldwide wealth will continue to accumulate faster than global GDP once the pandemic subsides and markets gradually normalise. As a result, WM businesses will provide stable and predictable earnings streams for established wealth management franchises, a shared credit strength of the five firms.

Strong, established wealth management franchises have benefited from steadily rising global wealth. Over the past five years, the five banks' wealth management and private banking businesses have benefited from solid net new money inflows, supported by rising global wealth, ultralow interest rates and strong capital markets. But ultralow rates also raised margin pressure, as clients placed rising cash balances in deposit notes, money markets and other fixed-income instruments. One small benefit of the coronavirus pandemic is that it has prompted clients to actively reconsider portfolio compositions, supporting the banks' previously suppressed trading income and raising the proportion of higher-margin products in client portfolios, such as equities or alternative investments.

Banks follow different strategies to capture wealth management share, and the strongest franchises can withstand fee pressure and contain costs. To grow assets under management (AUM[4]), the firms have variously pursued strategies of select talent acquisition, accompanied by mostly organic loan and deposit growth. While the two Swiss banks and JPM continued to build on their long-standing wealth management clientele, BAC and MS have been successful in converting their legacy brokerage franchises and clients into higher margin WM; the latter in part through acquisitions. As the race for profitable growth continues, and regulatory and client demands rise, fee pressure and rising costs could outpace revenue growth, potentially cutting into the benefits of the banks' large AUM bases.

Solid capitalisation and strong balance-sheet liquidity mitigate external risks. The five banks hold additional capital to offset the various reputational, legal and regulatory risks associated with entrusting a large base of financial advisors to appropriately manage clients' financial activities while maintaining a strong governance and control framework. This additional capital also buffers operational risks inherent to the banks' sizeable capital markets activities, helping protect their wealth management and brokerage franchises.

Click here for the full report.

Endnotes

1 We define wealth management (WM) activities as per the banks' segment disclosures detailed in the appendix. Our WM assets under management (AUM) exclude brokerage, custody and other client assets for the US banks and CS. UBS does not provide a detailed breakdown of its WM AUM as reported under its Global Wealth Management (GWM) segment and this report might therefore display additional AUM that have been excluded from its peers' WM AUM.

2 Ratings shown refer to group-level senior unsecured debt.

3 The ratings of UBS Group AG were not initiated or not maintained at the request of the rated entity. The ratings were initiated by Moody's. Please refer to Moody's Policy for Designating and Assigning Unsolicited Credit Ratings available on our **website**.

4 Throughout this report, AUM are defined as wealth management AUM, excluding brokerage, custody or other client assets. The figures may include double-counting as per the banks' disclosures.

Large US mortgage servicers can likely meet advance obligations in a highly adverse scenario

Originally published on 10 September 2020

The economic turmoil brought on by the coronavirus outbreak has had a profound impact on US residential mortgage originators and servicers, foremost via increased servicer advance obligations, which require servicers to make scheduled payments for loans that become delinquent or enter forbearance plans. However, our scenario analysis shows that the peer group of five Moody's-rated servicers will likely be able to meet their servicer advance obligations even in a highly adverse stress scenario.[1]

» **Forbearance levels rose quickly at the onset of the coronavirus crisis.** According to the Mortgage Bankers Association, 7.16% of US residential mortgage loans were on forbearance as of 30 August, lower than a peak of 8.55% in June. However, this percentage may well rise again given ongoing economic weakness, the persistence of new COVID-19 infections, as well as uncertainty over the level of continued fiscal support.

» **In a severe stress scenario, a servicer's advance obligations on $150 billion in unpaid principal could total $400 million.** If forbearance and delinquency rates double from current levels and borrowers remain on forbearance for the full 12 months allowed under the CARES Act,[2] we estimate that a servicer with $150 billion in unpaid principal, equally split among Fannie, Freddie and Ginnie-guaranteed mortgages,[3] would have aggregate servicer advance obligations over this period of around $400 million. Advances for Ginnie mortgages would make up around two-thirds of that amount.

» **Rated servicers have significantly increased their servicer advance funding capacity, allowing them to better withstand market shocks.** The companies' enhanced servicing advance facilities and liquidity will help them manage if servicer advance obligations increase materially.

» **Peak servicer advance obligations in a severe stress scenario vary materially from $1 billion to $80 million across the five rated servicers.** Despite this wide range, all five servicers – Quicken Loans, LLC (Quicken Ba1 stable), PennyMac Financial Services Inc. (PFSI Ba3 stable), Freedom Mortgage Corporation (Freedom B1 stable), PennyMac Mortgage Investment Trust (PMT Ba3 negative) and Provident Funding Associate L.P. (Provident B1 negative) – are well positioned to meet servicer advance obligations even in a severe stress scenario where borrowers remain on forbearance for a full 12 months (see Appendix for details). At the high end is PFSI, a large servicer with a significant proportion of Ginnie loans in its portfolio, with a peak liquidity need of around $1 billion. At the low end is Provident, a much smaller servicer without a material proportion of Ginnie loans, with a peak liquidity need of around $80 million.

Click here for the full report.

Endnotes

1 Given the wide range of practices being employed with non-government and non-agency loans with respect to servicer advances, for comparability this analysis focuses on the five rated residential mortgage servicers that predominantly originate agency and government loans.

2 Coronavirus Aid, Relief, and Economic Security Act

3 Fannie: Federal National Mortgage Association; Freddie: Federal Home Loan Mortgage Corporation; Ginnie: Government National Mortgage Association

Articles in last Monday's Credit Outlook

NEWS & ANALYSIS

Corporates

- ServiceMaster's sale of its franchise business will generate cash for debt reduction, a credit positive
- Ciena delivers solid results but outlook is weak amid Coronavirus disruption
- Acquisition would strengthen Veolia's international presence, but capital structure is unknown
- Li & Fung's weak first-half results are credit negative

Infrastructure

- For Long Beach Airport, Southwest Airlines filling all available slots is credit positive
- Brazil's enhanced regulation will spur natural gas market growth

Banks

- BPER Banca's acquisition of 532 Intesa Sanpaolo branches is credit positive

Sub-Sovereigns

- France's plan to substitute business tax proceeds with VAT revenue is credit positive for French regions

CREDIT IN DEPTH

- Europe's tourism exposure is concentrated in the southern region, but credit profiles remain resilient
- Credit implications of emerging markets' higher debt will depend on persistence of shock and policy buffers

Click here for last Monday's Credit Outlook.

Editors

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