Credit Outlook

30 November 2020

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McCormick's planned acquisition of Cholula is a credit negative

Originally published on 24 November 2020

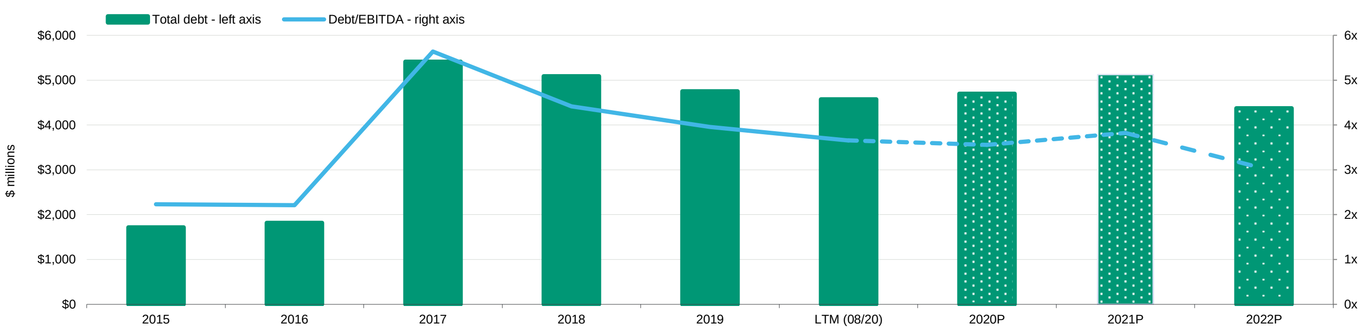
On 24 November, McCormick & Company, Incorporated (Baa2 stable) announced a definitive agreement to acquire the parent company of the Cholula Hot Sauce brand from *L* Catterton for $800 million in cash. Management plans to finance the acquisition with cash and commercial paper.

The transaction is credit negative because it will be debt financed and increase leverage. However, Cholula is a strong well established brand that will enhance the company's scale and product diversity and add meaningful margin accretion to the company's Consumer and Flavor solutions segments. The acquisition of Cholula is in line with McCormick's strategy of creating value through acquisitions by growing newly acquired brands through channel penetration, optimized brand management, and new product innovation.

Furthermore, we expect McCormick's leverage to remain within our expectations for the Baa2 rating given the company's operating profile. Based on our estimates, we anticipate the acquisition of Cholula will increase McCormick's leverage by roughly a half turn.

We forecast McCormick's Moody's-adjusted debt to EBITDA ratio at 4.2x pro forma for the acquisition, as of the third quarter (31 ended August). Our Baa2 rating and stable outlook for McCormick assumes that the company will remain acquisitive and that debt to EBITDA will be below 4.5x. With $1 billion in debt maturities (3.9% notes due 2021 and 2.7% notes due 2022) in the next two years, we believe McCormick will be able to quickly pay down debt and reduce leverage (see exhibit).

McCormick's debt and debt to EBITDA, with our projections through 2022



Moody's-adjusted debt and Moody's-adjusted debt/EBITDA
Sources: Moody's Financial Metrics and Moody's Investors Service estimates

In 2020, McCormick expects Cholula to generate approximately $96 million in annual sales and $32 million in EBITDA. McCormick expects the brand to grow in the mid to high single digits in a normalized environment beyond the coronavirus pandemic. The company expects the acquisition to realize approximately $10 million in annual cost synergies by fiscal 2022 (ending 30 November 2022) and to result in approximately $35 million in one-time transaction costs. Lastly, the Hart-Scott-Rodino waiting period has expired and the transaction is expected to close in calendar year 2020.

McCormick & Company Inc., headquartered in Sparks, Maryland, is a global player in the manufacture, marketing and distribution of cooking ingredients with an overall number one market share position in herbs and spices. Revenue was $5.5 billion for the 12 months that ended 31 August 2020.

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Analog Devices' solid results and strong outlook underscore improving market demand

Originally published on 24 November 2020

On 24 November, semiconductor maker Analog Devices, Inc. (Baa1 stable) reported a 6% year-over-year revenue increase to $1.54 billion for its fiscal fourth quarter that ended in October. The credit-positive results exceeded both our expectation of no growth and ended six consecutive quarters of revenue declines.

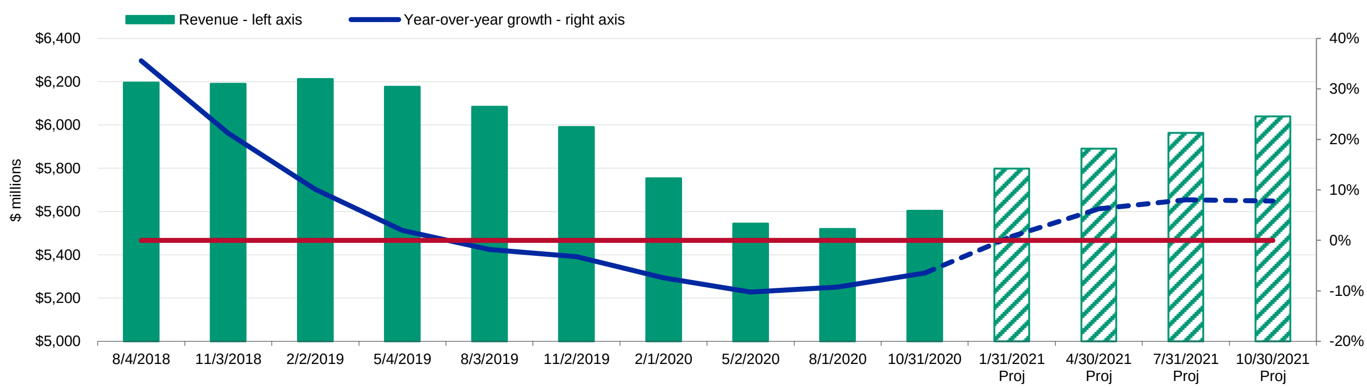
And while the macro-environment remains fluid, the company forecast a robust 15% year-over-year revenue growth next quarter, much better than its peers' revenue growth forecast of 6% for Texas Instruments, Incorporated (A1 stable) and 8% NXP Semiconductors N.V. Analog cited particular strength in its broad industrial and automotive end markets (combined 68% of revenue) as well as growth in its communications end markets (5G and wireline), despite lower revenue from Huawei because of export restrictions.

Following Analog's projected 15% revenue growth for the January quarter, we are assuming mid-single-digit growth for the rest of fiscal 2021, leading to approximately $6 billion of revenue, effectively back to 2019 levels (see Exhibit 1).

Exhibit 1

Analog's revenue is in the process of bottoming out

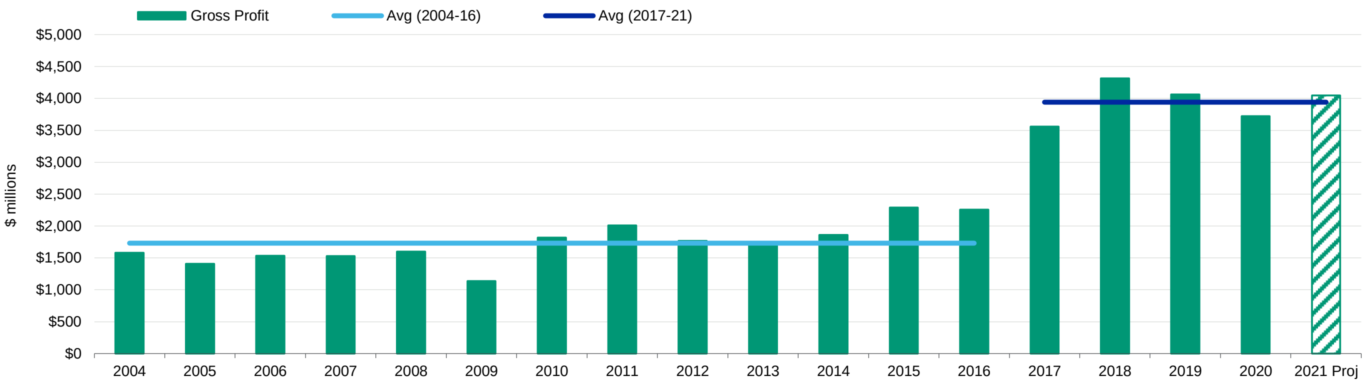
Trailing 12-month revenue and growth, year-over-year



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

Despite the coronavirus-driven downturn and related earnings decline in 2020, the company still generated solid profitability, margins and cash flow after capital spending. Gross margins on average are about 5% higher in recent years than the average between 2004 and 2016, and 9% higher in fiscal 2020 than in 2009 (see Exhibit 2).

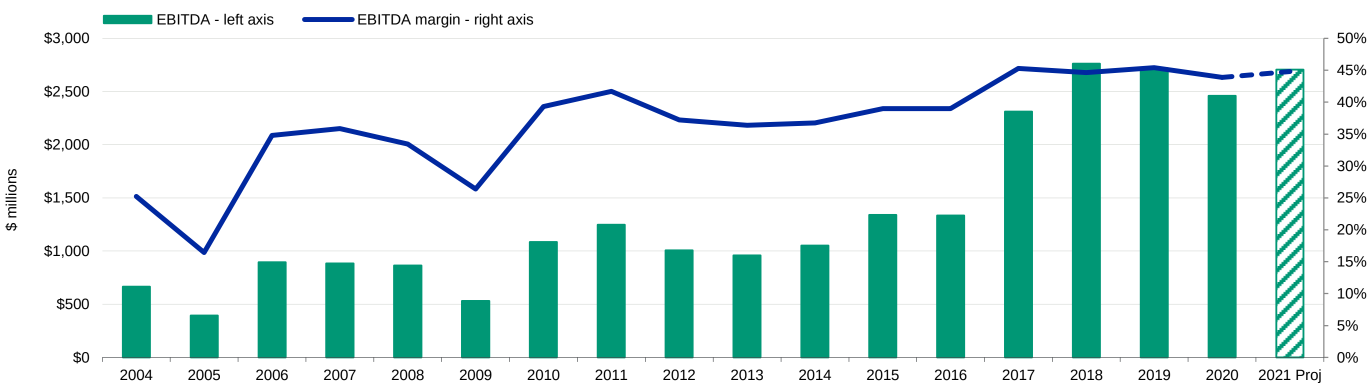
Exhibit 2
Analog's gross profit is structurally higher



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

Combined with good cost controls but steady spending on research and development, Analog generated $2.5 billion of EBITDA in 2020 and we project a record $2.7 billion in 2021 as EBITDA margins remain steady at around 45% (see Exhibit 3).

Exhibit 3
Analog's EBITDA is set to grow with steady margins

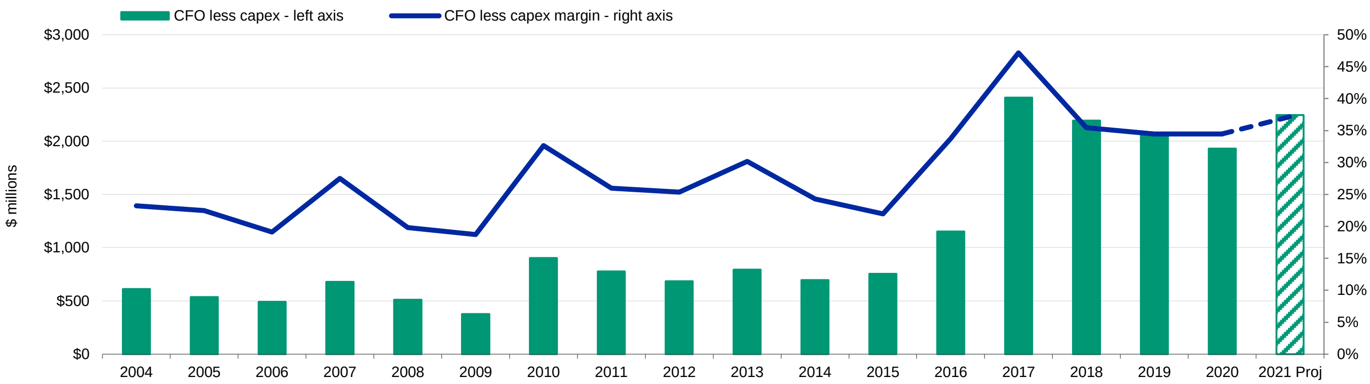


Sources: Analog, Moody's Financial Metrics and Moody's Investors Service projections

With Analog converting about 77% of its EBITDA into cash flow from operations less capital spending over the last seven years, we expect that the company will generate about $2.1 billion cash flow after capital spending in fiscal 2021 following $1.9 billion in 2020 (see Exhibit 4).

Exhibit 4

Analog's cash flow from operations less capital spending and margins were strong in 2020 and are set to grow in 2021



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

Analog will continue its commitment to a robust dividend return to shareholders, with a projected payout of approximately $925 million in 2021, which is nearly 3x what the company paid during the financial crisis in 2009. Despite the coronavirus-driven downturn, we project that Analog will generate about $1.2 billion in free cash flow (after dividends) in fiscal 2021 . Analog has generated positive free cash flow in every quarter over the last decade.

Throughout 2021, Analog will maintain a very strong liquidity profile. Analog's next debt maturity is December 2021, when a $400 million note comes due. As of October 2020, Analog had cash and short-term investments of $1.05 billion. Given the modest capital intensity of the high performance analog sector, a track record of consistent free cash flow generation through various periods of economic stress over twenty years, we consider the company's liquidity profile as excellent. Analog also maintains an unused $1.25 billion unsecured revolving credit facility that matures in June 2024.

Under these conservative assumptions, we project leverage would improve modestly, with adjusted gross debt to EBITDA of about 2.3x at the end of fiscal 2021, down from 2.5x this year. Similarly, the company's free cash flow to adjusted gross debt is projected at around 24%, up from 17% in 2020.

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Telesat Canada's planned merger with Loral to become public company is credit positive

Originally published on 25 November 2020

On 24 November, Telesat Canada (B1 stable) announced that it has a definitive agreement with its private owners, Loral Space & Communications Inc. and Public Sector Pension Investment Board (PSP), whereby Telesat will merge with Loral to form a new Canadian public company, Telesat Corporation. The transaction is credit positive because it will enable Telesat to raise public equity for its planned low earth orbit (LEO) satellite constellation or to possibly deleverage. The transaction is subject to shareholder and regulatory approvals and is expected to close in the second or third quarter of 2021.

PSP currently owns a 36.7% economic interest in Telesat, while Loral owns 62.6% and Telesat management owns 0.7% while PSP currently maintains 67% voting control and Loral 33%. Loral is a public company listed on the Nasdaq Global Select Market and its significant asset is its ownership stake in Telesat. When the transaction closes, the shareholders will own all of the shares in Telesat Corporation in the same proportion as their current holdings of Telesat. Telesat Corporation will trade on the Nasdaq exchange and the company is also considering a listing on a Canadian stock exchange. Telesat Corporation's governance provisions will ensure that the Board and voting control remain Canadian-controlled.

The combined company will have no incremental debt or incremental EBITDA as Loral is a shell company. Telesat plans to launch a constellation of 298 Ka-band LEO satellites that will deliver fiber-like broadband connectivity to commercial and government customers worldwide. Telesat has not made a firm commitment on the LEO constellation although it has indicated that an announcement on the constellation is likely by the end of 2020. While total cost is not yet released, Telesat has indicated that it expects funding to be in the proportion of one-third equity and two-thirds debt. With the merger announcement to become a public company, Telesat will be able to tap the public equity market to partially fund that project.

Telesat's leverage has been rising (5.7x as of the last 12 months to third-quarter 2020) because of the company's EBITDA contraction and a lack of debt reduction while it has built up a CAD1.2 billion cash position in anticipation of committing to the LEO project. We expect the conversion to a public company and the ability to issue public equity as well as debt will enable Telesat to mitigate a further rise in leverage associated with the buildout of the LEO project, but management's capital strategy for the project is not yet clear.

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AstraZeneca's COVID-19 vaccine safety and efficacy data brings positive social implications

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On 23 November, AstraZeneca PLC (A3 stable) announced that its vaccine candidate AZD1222 (ChAdOx1 nCoV-19), developed in partnership with the University of Oxford, had met its primary efficacy endpoint in preventing COVID-19. The interim trial results have positive credit implications, primarily on AstraZeneca's social standing.

The interim analysis reported 23 November showed a vaccine efficacy rate between 62% and 90% depending on dosing regimen, based on the first 131 instances of COVID-19 infection among participants in the trial in the UK and Brazil. In addition, there were no adverse events relating to safety and tolerability of the vaccine candidate. However, the trial is not yet complete and continues in the US, Japan, Russia, Africa and Latin America, while important details such as the split of infections between the vaccine and the placebo groups are not available yet. AstraZeneca will apply for early or conditional approval of the vaccine in jurisdictions where there is such a framework, which includes the US, EU and UK.

Positive social implications primarily relate to demographic and societal trends as well as customer relations categories within our ESG framework. They include societal benefits in terms of social responsibility as well as access and affordability of medicines, enhanced by AstraZeneca's commitment not to profit from the vaccine during the pandemic (or in perpetuity in developing countries, for which around one billion doses are currently earmarked). At the same time, we have previously commented that additional societal benefits may also include reduced mortality, lower burdens on hospitals and an easing of social distancing measures. AstraZeneca could also achieve improved customer relations with patients, healthcare professionals and authorities.

AstraZeneca has secured one of the largest COVID-19 vaccine manufacturing capacities with up to 3 billion doses planned for 2021, based on a two-dose regimen, administered at least 30 days apart. The half-a-dose plus one dose regimen has shown higher efficacy than the full two-dose, hence the vaccine may be available to more people with the agreed supply. Even if the vaccine can be stored at standard refrigerated temperatures and has a shelf life of at least six months, there are executing risks associated with its wide distribution across the world.

AstraZeneca's commitment not to profit from its COVID-19 vaccine during the pandemic limits the potential upside on the company's EBITDA and cash flows. Ultimately, this will depend on the competition from other vaccines, the duration and severity of the pandemic, which will determine the required volume of vaccines and the need for and frequency of re-vaccination. AstraZeneca is the third pharmaceutical company to report pivotal data on a vaccine candidate after Pfizer, Inc. (A2 stable), in collaboration with BioNTech, and Moderna, which have both shown efficacy of at least 90% and good safety and tolerability.

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Enhanced greenhouse gas emissions target will improve Diageo's environmental footprint

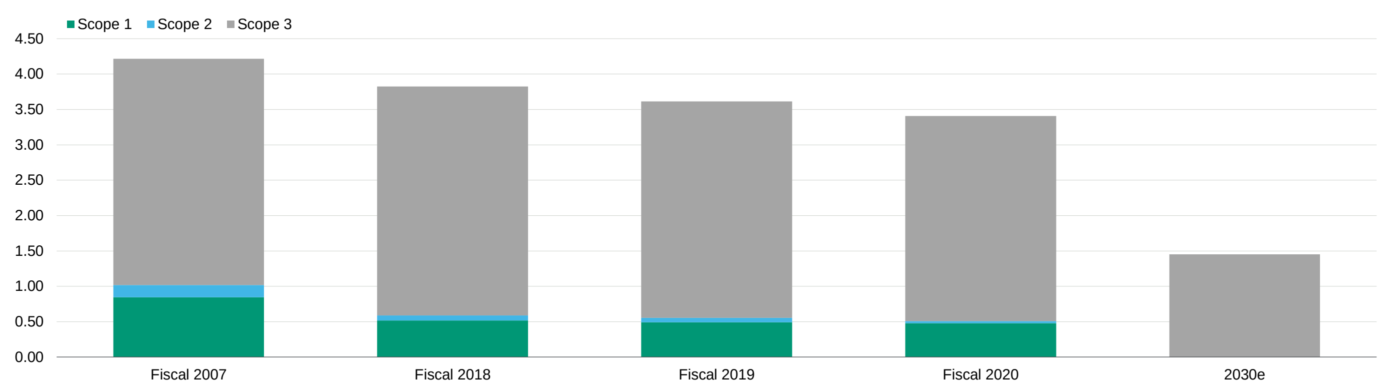
Originally published on 26 November 2020

On 23 November, UK-based alcoholic beverage maker Diageo PLC (A3 stable) announced that it plans to decarbonise its operations and reduce by half the greenhouse emissions it generates along its supply chain by 2030. The initiative enhances Diageo's environmental credentials and because the initiative exceeds its major competitors' current carbon offset efforts, it is likely to strengthen the company's brand position amid growing environment awareness, despite a cost in terms of additional investments.

We estimate that the additional costs for Diageo to reduce its greenhouse gas emissions and to improve the overall environmental footprint of its activities will be around £300 million a year. The effort will involve developing advanced distilleries and brewery facilities using the latest European technology, and account for nearly half its total annual capex. These investments equal around 30% of its annual free cash flow pre-conoravirus pandemic and around 2.0% of its £17.1 billion gross debt as of 30 June 2020. Failing to invest in environmentally friendly equipment and processes not only exposes Diageo to increased taxation but also reputational market risk as consumers increasingly prefer products that are perceived as more socially responsible.

Diageo has already reduced its own greenhouse gas emissions by 50% over the past decade to around half a million tonnes, including both direct and indirect emissions. However, the emissions generated along its supply chain totaled 2.9 million tonnes at the end of fiscal 2020 (which ended 30 June 2020). As shown in the exhibit below, the company's new 2030 target is a new commitment for the next decade and is in line with the measures proposed in the "European Green Deal," which aim to reduce the greenhouse gas emissions of countries in the European Union (EU) by 50% over the next decade.

Diageo has halved its own (Scope 1 and 2) greenhouse gas emissions since 2007, and plans to be carbon neutral and halve its Scope 3* emissions by 2030
Million tonnes carbon dioxide emissions



* Direct and indirect gas emissions include both "Scope 1" and "Scope 2" emissions, which included both direct emissions from the activities of a company or under its control as well as those not directly generated by the company but under its control. However, they do not include "Scope 3" emissions, which include all other indirect emissions from suppliers, which usually represent the majority of the carbon footprint of any organisation.
These definitions are included in the standards put forth by the Greenhouse Gas Protocol, a partnership between the World Resources Institute and the World Business Council for Sustainable Development. Adopted by many companies, including Diageo, the Greenhouse Gas Protocol provides accounting and reporting standards for business and government and establishes a comprehensive, global, standardized framework for measuring and managing emissions.
Source: Company information

Diageo has exceeded Pernod Ricard S.A.'s (Baa1 stable) progress in reducing its greenhouse emissions, with Pernod having reduced its carbon emissions per unit produced by 32.9% between 2010 and 2020. Diageo's new targets commit the company to reducing its greenhouse gas emissions by 100% by 2030, versus Pernod's commitment to reduce them by a further 30% over the same period.

The importance of meeting greenhouse gas emission targets will increase over the next few years. Indeed, the EU is already considering imposing a carbon border tax that would reflect the amount of carbon emissions attributed to goods imported into the 27-nation region and potentially increase the costs to be sustained to reduce greenhouse emissions. Currently, distilleries are subject to the EU Emissions Trading System (EU-ETS), which has not greatly affected companies' earnings or business models. The EU represents around one-quarter of all Diageo sales by value.

The company's free cash flow generation has already substantially weakened and will remain depressed in fiscal 2021 because of government lockdown measures aimed at slowing the pandemic. In the 12 months to June 2020, Diageo's free cash flow as defined by Moody's was a negative £164 million, driven by a sharp decline in cash flow from operations (CFO, as defined by Moody's), down to £2.4 billion from £3.4 billion in fiscal 2019, and dividends paid of £1.8 billion, virtually unchanged from fiscal 2019. Additional taxes and investments to accommodate further changes in European environmental legislation could challenge the company's free cash flow generation and its ability to reduce debt.

Diageo's leverage, measured in terms of Moody's-adjusted gross debt to EBITDA, has deteriorated to 4.1x as of 30 June 2020 from 3.0x in December 2019, driven by an increase in gross debt to £17.1 billion from £14.5 billion over the same period as a result of the issuance of new bonds to strengthen liquidity, and a 13% decline in EBITDA to £4.1 billion in fiscal 2020. We expect that Diageo's leverage will further increase in fiscal 2021, likely peaking in the first half of the fiscal year and recovering gradually thereafter, as trade restrictions on restaurants and bars are eased and upcoming debt maturities repaid.

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Danone restructuring costs will add pressure to its credit metrics, a credit negative

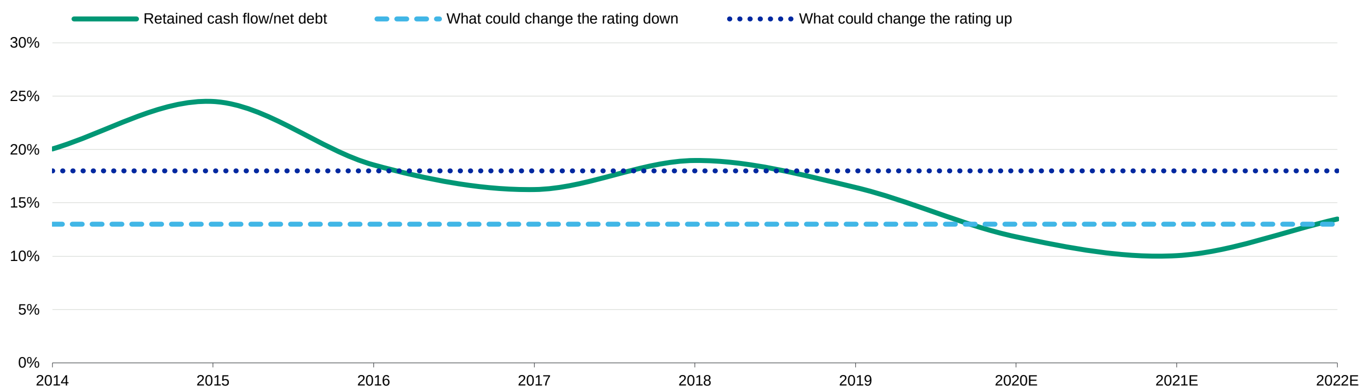
Originally published on 23 November 2020

On 23 November, Danone (Baa1 stable) presented a new restructuring plan aimed at revamping the company's sales growth and restoring profitability following the negative effects caused by the coronavirus pandemic. The announcement is credit negative because the planned restructuring costs will add pressure to credit metrics over the next 24 months.

Some of the measures include simplifying its product portfolio and a cost-savings programme. In particular, Danone targets to achieve €1 billion of cost savings by 2023, of which €700 million will come from the reduction of overhead and €300 million from efficiencies on logistics and cost of goods. The personnel reduction plan will have a one-off cost of €1.4 billion to be split over the next three years.

The plan is aimed at allowing the company to return to its trajectory of improving margins. The pandemic has strained the company's sales and operating profit mainly because of the exposure of Danone's water division to out-of-home consumption, which has been disrupted by lockdown measures. As a result, we project that the company's recurring operating profit will decline by high single digits in 2020, with Moody's-adjusted gross debt/EBITDA increasing to close to 4.5x from 3.9x in 2019 and retained cash flow/net debt deteriorating to below 13%, which are weak for the current rating.

One-off costs will weight on Danone's credit metrics, absent any mitigating action
Retained cash flow/net debt



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

In our forecasts, we had assumed a degree of improvement in credit metrics in 2021 as business activity resumes. However, the large amount of one-off costs related to the new restructuring plan will impair cash flow generation over the next two years, slowing the deleveraging process and weighing on credit metrics.

In particular, we expect that Danone's retained cash flow/net debt will remain below 13% in 2021 as well, which would leave the rating weakly positioned in the Baa1 rating category. We expect metrics to gradually improve from 2022 as the cost savings measures gain traction. However, this is subject to execution risk because of the large size of the headcount reduction plan. Danone targets reducing headcount by up to 25% of its workforce in its central and local headquarters.

Danone has a number of levers to mitigate the effect of this restructuring plan on its credit metrics, including the disposal of noncore assets. The company has already indicated it is considering options for its business in Argentina and for its Vega brand (plant-based nutritional products), and the company could dispose of additional assets as it carries on its business strategic review. Proceeds from these potential disposals could be used to fund the restructuring plan, alleviating pressure on credit metrics.

Moreover, Danone is committed to its Baa1 rating and its prudent financial policy continues to be a key rating driver. Following the White Wave acquisition in 2017, Danone adopted a number of measures to preserve cash and to reduce debt, including the issuance of a €1.25 billion hybrid instrument and the payment of a scrip dividend in both 2017 and 2018. We believe Danone could chose to take similar measures in the future in case the restructuring plan does not deliver the expected results or the recovery of operating performance is slower than anticipated.

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SIG Combibloc's planned acquisition of remaining shares in Middle East and Africa joint venture is credit positive

Originally published on 25 November 2020

On 25 November, SIG Combibloc Group AG (SIG, Ba2 stable) announced that it has signed an agreement to acquire the 50% shareholding of its partner Obeikan Investment Group (OIG) in SIG Combibloc Obeikan, the Middle East and Africa (MEA) joint venture between SIG and OIG. The consideration for the acquisition will include €167 million in cash and 17.5 million SIG shares. The deal is subject to regulatory and other customary approvals.

The acquisition is a strategically positive expansion of SIG's global presence in a growing market where the company has deep insight over many years of the joint venture operations. The transaction will give SIG full control of the MEA business while also being slightly deleveraging.

SIG will also retain the management talent with Abdallah Al Obeikan, CEO of OIG and SIG Combibloc Obeikan, expected to join SIG's board of directors. Also, Abdelghany Eladib, COO of SIG Combibloc Obeikan, is expected to become SIG's president and general manager for Middle East and Africa.

SIG Combibloc Obeikan is present in 17 MEA countries including a full scale manufacturing plant in Ryadh, Saudi Arabia, and serves over 70 customers in the region. SIG Combibloc Obeikan provides complete aseptic carton packaging systems, which include aseptic filling machines, aseptic cartons, spouts, caps and closures and support services. It will add approximately €200 million of revenue after inter-company eliminations and €80 million of EBITDA to SIG's results (which will be offset by the elimination of a €20 million dividend that had been previously received from the JV).

Positively, SIG is expected to finance the transaction conservatively, with equity and cash on hand. OIG will receive shares equivalent to approximately 5% of SIG's share capital on a fully diluted basis. Because of its prudent funding strategy, we expect SIG's pro forma leverage to decline to 3.5x from 3.9x for the 12 months that ended June 2020.

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Castellum's acquisition of Entra is credit positive, and offers significant long-term benefits

Originally published on 27 November 2020

On 26 November, Castellum AB (Baa2 stable) announced its intention to launch a share exchange and cash offer to Entra ASA (Baa1 stable) shareholders, combining Castellum and Entra to create one of the bigger listed companies in Europe, a credit positive for Castellum because of added diversification and public sector exposure.

The bid, equating to NOK170.86 per Entra share, is a premium of 30.8% to Entra's volume weighted average share price for the three months that ended 23 November 2020. The total acquisition amount is NOK30.8 billion, which Castellum intends to finance largely with newly issued shares, representing 85% of the purchase piece, and the remaining 15% will be financed in cash. The offer is expected to last for 20 business days and requires more than 90% of Entra's shareholders accepting the offer. The total cash consideration payable of NOK4.6 billion, is fully covered by Castellum's cash on hand and a new NOK30 billion bridge facility arranged by J.P. Morgan Securities plc and Danske Bank. Also, Entra's outstanding debt, which is subject to change of control provisions, can be covered by additional backstop facilities available to Castellum. This transaction is surrounded with execution risk because there is a formal rival bid from the real estate company Samhällsbyggnadsbolaget.

The combination with Entra will create a larger player in the Scandinavian office market with a combined portfolio size of SEK148 billion, from SEK98 billion for Castellum alone. In addition, the transaction adds diversification through adding a new country and will increase Castellum's public sector exposure. Occupancy will increase to 94.7% from 93.4% for the 12 months to September 2020 and at the same time its WAULT will increase to five years from four years. Initially the share of the portofolio in large cities will decrease to 70% from Castellum's current 73%, but we assume it likely that Castellum will make divestments in smaller, less attractive cities.

This transaction will provide long-term benefits because Castellum can build on Entra's strong position in attractive positions in Oslo and modern high quality portfolio with a large share of government tenants in Norway while maintaining key personnel, which reduces the potential risk of cultural challenges between the companies. Pro forma for the transaction, Castellum's Moody's-adjusted debt to assets ratio will remain below 45%, and is in line with current rating guidance and net debt to EBITDA will increase to 11x from 10.2x as of the 12 months to September 2020.

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China Hongqiao's share placement is credit positive

Originally published on 25 November 2020

On 25 November, Chinese-based leading aluminium producer, China Hongqiao Group Limited (Hongqiao, B1 stable) announced its intention to raise around HK$1.9 billion through share placement. The transaction is credit positive because it further improves the company's liquidity and demonstrates its diversified funding channels.

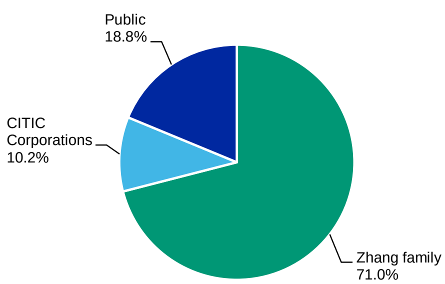
New shares will account for about 3.5% of the total shares after the transaction. Shares owned by the controlling shareholder, the Zhang family, will decrease from about 71.0% to 68.5% after the transaction.

Hongqiao plans to use the proceeds from the placement for the development of production lines for secondary aluminium and lightweight materials, and general working capital purposes.

The equity fundraising favors creditors as it improves Hongqiao's capital structure and liquidity. The transaction provides Hongqiao with more flexibility in managing it concentrated upcoming maturing debt in the first half of 2021.

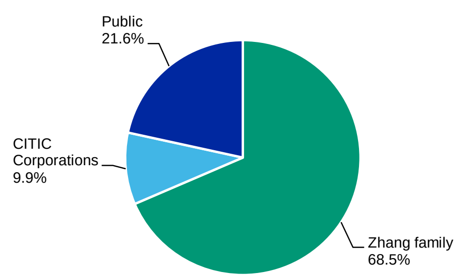
The transaction also demonstrates Hongqiao's diversified funding channels and a balanced use of both debt and equity. Hongqiao has raised equity funds frequently during 2014-20, including selling a 10% stake to its strategic shareholder, CITIC Group Corporation (A3 stable), in 2017.

Exhibit 1
Shareholding structure before the transaction



Sources: Company and Moody's Investors Service

Exhibit 2
Shareholding structure after the transaction



Sources: Company and Moody's Investors Service

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New support measures will soften second lockdown's effect on French banks

Originally published on 27 November 2020

On 26 November, French Prime Minister Jean Castex and Minister of Labor Elisabeth Borne announced additional support for the most vulnerable workers. The measures followed President Emmanuel Macron's 24 November announced three-stage process to gradually lift France's second coronavirus lockdown, in place since October, and new measures to extend economic support forthe most affected companies and employees, which will likely ease pressure on borrowers and help shield the country's banks from loan defaults.

Part-time employees who were able to work 60% of the time in 2019 but could not work in 2020 will benefit from an allowance of €900 a month from November 2020 to February 2021. This measure will benefit 400,000 employees in precarious jobs including restaurant and entertainment workers. Some 20,000 new jobs will also be created and emergency aid doubled for students.

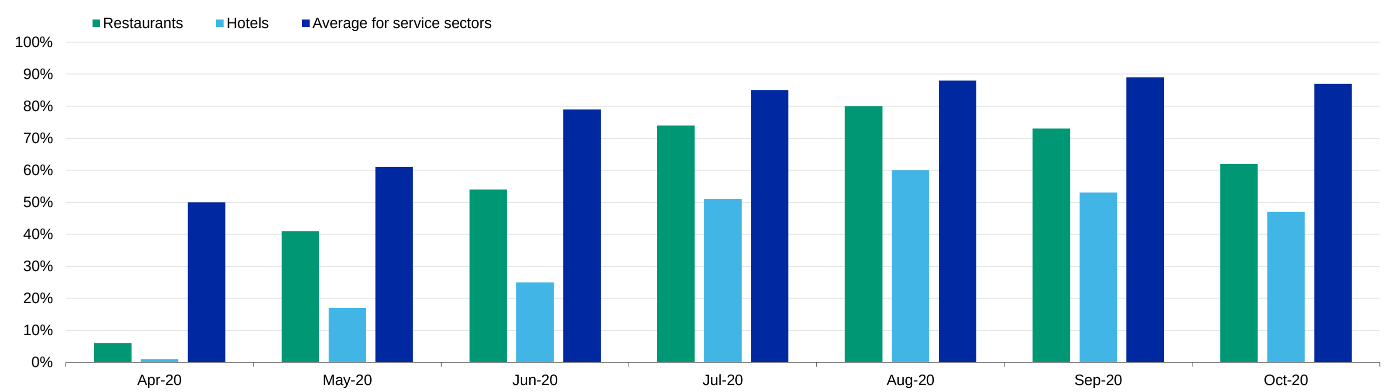
The French government has supplemented its "Solidarity Fund"[1]. Companies of all sizes subject to compulsory closing will now have the choice of either a tax-free state allowance of up €10,000 a month, or 20% of the revenue they reported at the same time last year, capped at €100,000. The new measure will benefit around 200,000 companies and will cost public finances €1.6 billion a month, according to French Finance Minister Bruno Lemaire.

The easing of lockdown measures will take place in three steps. As a first step, non-essential retailers and other services will reopen on 28 November. The second step will be a reopening of cultural buildings and events on 15 December signaling the end of lockdown, but with a 9pm to 7am curfew. Ski resorts will, however, be closed until at least the end of the year. As a final step, restaurants and bars will be allowed to resume activity in mid-January. The government made clear that the planned relaxation of rules will depend on a continued downward trend in coronavirus caseloads.

In October, the government extended its programme of state-guaranteed loans, in place since 25 March, for companies in all sectors to 30 June 2021 from year-end 2020. After a grace period of one year, the cost of these loans for borrowers will be 1.0%-2.5% of the outstanding amount including the guarantee fee. The costs are materially higher than before,[2] but remain low. The grace period can be extended by an additional year in the event of need. As of mid-November, around 600,000 companies benefitted from a state-guaranteed loan (PGE) for a total amount of around €125 billion.

Hotels and restaurants are among those most severely affected by lockdown. Many had not fully recovered from the first lockdown when the second lockdown took effect in October (see exhibit).

Based on business survey, hotels and restaurants are among the hardest hit service companies
Business leaders' assessment of monthly activity as a percentage of normal business volumes



Source: Banque de France

Hospitality and leisure companies represent 4% of total domestic corporate debt, which is equal to their contribution to 2019 GDP. However together they represent less than 2% of the large French banks' loan books. The marginal cost of risk implied by worsened financial conditions at these firms could be material but will likely remain within limits the banks can absorb with their recurring earnings.

Endnotes

1 The Solidarity Fund was established to provide direct support of up to €1,500 (up to €10,000 in certain cases) to small businesses until the end of June. It had previously been extended until the end of 2020 for companies in the most affected sectors.

2 The cost of state-guaranteed loans is 25-50 basis points during the grace period.

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KCB Group's acquisitions in Rwanda and Tanzania will strengthen its regional presence

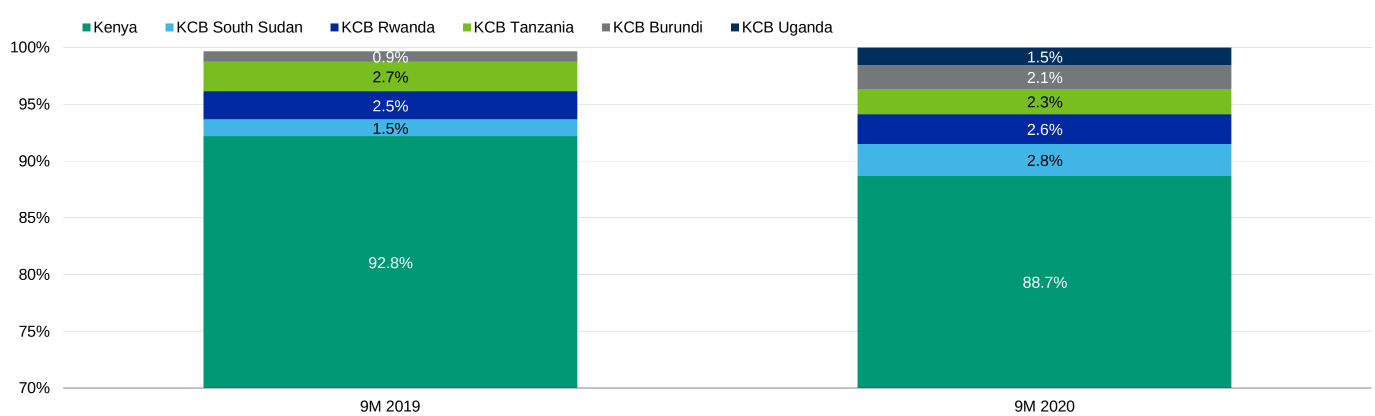
On 26 November, KCB Group Plc, the holding company of KCB Bank Kenya Limited (B2 negative, b2[1]), announced that it had reached a definitive agreement with Atlas Mara (ATMA) to acquire controlling stakes in Banque Populaire du Rwanda Plc (BPR) and African Banking Corporation (BancABC) in Tanzania. The deals are credit positive for KCB Group because it will likely merge the two entities with its existing subsidiaries in Rwanda and Tanzania, strengthening its market shares and distribution network, and creating opportunities to cross-sell products to a wider base of customers.

The acquisitions are relatively small for KCB Group, which had a book value of KES136 billion ($1.2 billion) as of September 2020. KCB Group will acquire ATMA's 62% stake in BPR and 100% stake in BancABC Tanzania. KCB Group will pay around 1.09x book value (RWF50 billion or $51 million for a 100% stake as of June 2020) for BPR and 0.42x book value (we estimate the dollar amount to be less than $10 million) for BancABC Tanzania. The actual amount KCB Group pays will be based on the final book value of the two banks at completion of the transactions. KCB Group also aims to make an offer to the remaining shareholders of BPR to acquire their shares on the same terms as those agreed with ATMA. Arise BV, which is backed by Norfund, Rabobank (Aa3 stable, a3) and the Dutch multilateral development bank FMO, holds another 14.6% stake in BPR.

In Rwanda, KCB Group will likely double its market share on completion of the acquisition to become the second-largest bank in the country. In Tanzania, the subsequent merger of BancABC with KCB Bank Tanzania will integrate the two banks' retail, commercial and corporate banking franchises, ranking them as a top 10 bank. Pending shareholder and regulatory approvals in the respective countries, and other customary conditions, the two banks expect the deal to close in the first half of 2021.

KCB Group's strategy is to explore growth opportunities and strengthen its regional position in East Africa. It already has subsidiaries in six countries (Kenya, Tanzania, Rwanda, South Sudan, Uganda and Burundi) and a representative office in Ethiopia, which combined contributed around KES2 billion of profit before tax (or around 11% of KCB Group's KES17.1 billion profit after tax) for the first nine months of 2020 (see exhibit). While there is limited financial information available on ATMA's subsidiaries, BPR is profitable while BancANC Tanzania is loss-making. As such, we estimate that after the acquisition the regional contribution to KCB Group's profit before tax will likely increase to 13%-14%. The transaction does not have any credit effect on KCB Group's largest operating entity, KCB Bank Kenya Limited, which focuses on its home market of Kenya.

KCB Group's regional breakdown of profit after tax



Source: KCB Group

Endnotes

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

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Cash reserves with central bank increase for Nigeria's largest five banks, harming interest income

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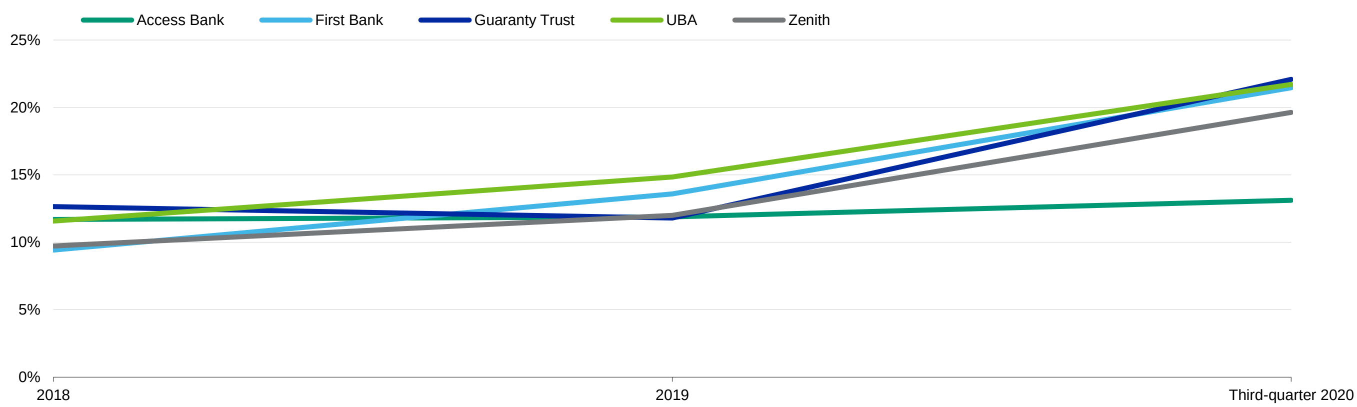
On 20 November, three of Nigeria's five largest banks reported third-quarter results showing that restricted deposits for the five largest banks had risen to NGN6.7 trillion in September, a 120% increase from a year earlier. Restricted deposits are unremunerated reserves kept at the central bank for regulatory purposes and include deposits the central bank withdraws from banks as a penalty when banks fail to meet their required minimum loan-to-deposit ratio of 65%. As a result, restricted deposits now account for 19% of combined total assets for Nigeria's five largest banks, up from 13% at year-end 2019 and 11% in 2018 (Exhibit 1). This high volume of unremunerated cash reserves is credit negative because it weakens banks' revenue-generation capacity, hurting profitability.

Exhibit 1

Nigerian banks' restricted deposits increased, on average, to 19% of total assets as of the end of September from 13% in 2019 and 11% in 2018

Ratio of restricted deposits/total assets



UBA is United Bank for Africa Plc. We use FBN Holdings' numbers as a proxy for First Bank of Nigeria Limited

Sources: The banks and Moody's Investors Service

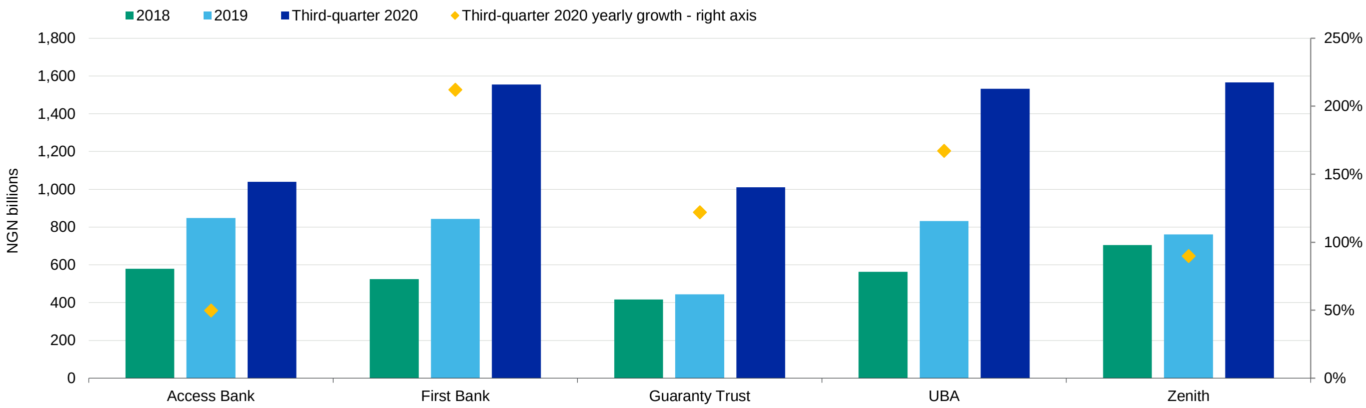
The three banks that reported were Zenith Bank Plc (B2 negative, b2[1]), United Bank for Africa Plc (B2 negative, b2) and FBN Holdings, parent of First Bank of Nigeria Limited (B2 negative, b3). Together with Access Bank Plc (B2 negative, b3) and Guaranty Trust Bank Plc (B2 negative, b2), which reported third-quarter results earlier in November, these five largest banks in Nigeria combined account for about 70% of the country's banking assets.

Since July 2019, Nigerian banks must lend a minimum of 65%[2] of their deposits or risk a penalty of 50% of the lending shortfall as a cash reserve requirement. The directive, together with Nigeria's high cash reserve requirement of 27.5% on naira-denominated deposits, aims to reduce excess naira liquidity in Nigeria's money markets while forcing banks to lend. Though these banks expanded their gross loans by a significant 17% in September from a year earlier, their loan-to-deposit ratios averaged 48%[3] in September, below the 65% minimum requirement, resulting in higher restricted deposits with the central bank as a penalty.

The high amount of restricted deposits with the central bank reduces the amounts that banks can lend or invest at a time when banks' revenue growth is strained by falling interest and fee and commission margins. Combined interest income for the banks declined by 1.4% in September from a year earlier. If the banks' restricted deposits earned a yield of 15.2615%[4] per year, we estimate that the five banks would have generated about NGN223 billion in additional interest income, representing a 14.5% increase on their interest income reported in September. The restricted deposits are also a cost to banks because they still must pay interest on these deposits.

As of the end of September, Zenith had the largest volume of restricted deposits at about NGN1.565 trillion,[5] while Guaranty had the smallest at NGN1.01 trillion. Restricted deposits for First Bank and United Bank for Africa were also above NGN1.5 trillion. First Bank's restricted deposits increased the most at 212% from September 2019 (Exhibit 2).

Exhibit 2
Nigerian banks' volume of unremunerated restricted deposits increased substantially this year
Cash reserves



We use FBN Holdings' numbers as a proxy for First Bank.
Source: The banks and Moody's Investors Service

Yearly profit growth for the first nine month was 5%[6] on average for the largest five banks, but their combined un-annualised return on assets declined to 1.6% as of September from 1.9% a year earlier. We expect low profit growth this year as a result of slower revenue growth and higher provision costs.

However, although these banks are penalised for failing to meet the loan-to-deposit requirement, their relatively tight lending stance is positive given Nigeria's challenging operating environment. We expect their nonperforming loans, which averaged 6.8% of their gross loans, to increase to 8%-10% in the next 12-18 months as the coronavirus pandemic, low oil prices and preexisting economic challenges weigh on economic activity and borrowers' repayment capacity. In addition, the large stock of reserves, although unremunerated, provides an extraordinarily high liquidity buffer for the system and we expect the central bank to release it in the event of a liquidity crunch.

Endnotes

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

2 The calculation of this ratio is imprecise because different weights are assigned to loans extended to different industries, and deposits are not strictly customer deposits, but include other funding instruments.

3 This ratio is unweighted and considers only customer deposits, but we use it as a proxy to gauge banks' compliance with the directive.

4 This was the yield of a 361-day Open Market Operations bills issued on 3 January 2020. The interest rate on OMO bills of similar tenors declined to around 6.75% in November.

5 As a percentage of total assets, Zenith's ratio at 20%, is lower than United Bank for Africa's 22%, Guaranty's 22% and First Bank's 21%.

6 First Bank's profit grew by 32% and Access' by 13%, supported by trading and revaluation gains. Zenith's profit increased by 6%, while profits for United Bank for Africa contracted 6% and Guaranty contracted 3%

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Tax cuts weigh on Czech Republic's already challenging fiscal dynamics

Originally published on 24 November 2020

On 20 November, the lower house in the Czech Republic (Aa3 stable) approved a package of tax reforms, which include sizeable cuts to the rate of personal income tax. We expect the Senate to approve the package. The tax package is credit negative for the sovereign because the associated fall in revenue is expected to more than offset the potentially positive fiscal impact of the anticipated boost to private consumption. Hence, the tax cuts are set to prolong the deterioration in fiscal and debt metrics triggered by the coronavirus crisis. The cuts are also credit negative for the country's regional and local governments (RLGs) as they will weaken operating performances and lead to further delays in capital expenditure which are crucial to the Czech economy's long-term economic growth.

The package includes as its key feature a cut in the main rate of personal income tax (PIT) to 15% from 20.1%, which the Prime Minister Andrej Babis pushed through despite the opposition of his own coalition partners. According to Mr. Babis, the change is expected to lead to a revenue loss of CZK79 billion or 1.4% of GDP. The government has also proposed removing the ceiling on personal income tax credit and lowering the rate of excise tax on diesel.[1]

According to Finance Minister Alena Schillerova the total fiscal impact of the tax changes will reach CZK130 billion annually (2.3% of GDP), CZK87 billion of which will come from the state government budget. However, these measures were not included in the 2021 budget's CZK320 billion deficit target. As a result, there is no plan at this stage on how the budget will accommodate for this loss of revenue.

The Senate still needs to approve these changes. However, the income tax cut is unlikely to face opposition there because it passed the lower house with support from both the ANO and the main opposition party. That said, if approved, the limited time frame means the changes are unlikely to come into force until the spring.

These tax changes are in addition to the extension of other stimulus measures like wage and rent subsidies in the most affected industries and extra benefits for self-employed workers that the government agreed on in November when it tightened restrictions in response to steadily rising infection rates. The tax changes also coincide with an expansionary budget next year, which was introduced to parliament on 11 November. The budget will scrap the real estate transfer tax, increase pensions and teachers' salaries and boost spending on healthcare. Collectively, the government forecasts a deficit target at the state government level of CZK320 billion or 4.9% of GDP. According to the National Budget Council, the finance ministry's proposal for 2021 implies a structural deficit of 4.5% of potential GDP, above the limit set by the budget responsibility law of 4%.

Based on our current deficit forecast of 5.3% of GDP for next year, we expect the general government debt burden will increase to 42% of GDP by year-end 2021, up from 30% in 2019. There is still room until the 55% of GDP debt break, which would force the government to include measures to protect the long-term sustainability of the public finances in the next budget. However, a general election next year could intensify spending pressures and increases risks to our fiscal forecasts.

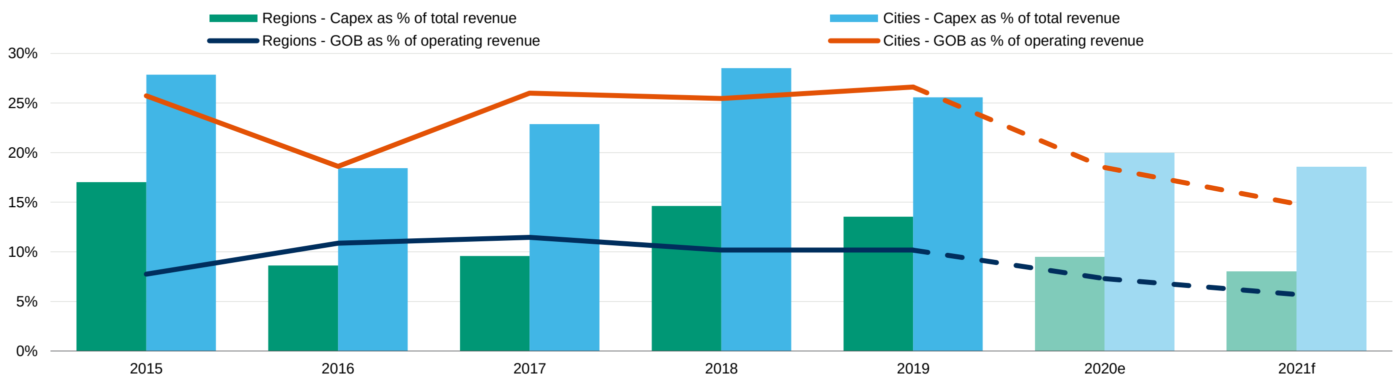
Decline in PIT will weaken RLGs' operating performance and trigger a fall in capital expenditures. Shared taxes, a key revenue source for Czech RLGs at around a third of the regions' operating revenue and two-thirds of the cities´ operating revenue, will significantly decline in 2021. We expect the collection of personal income tax (PIT) will fall 30% for both regions and cities compared to estimated 2020 figures. This will lead to deterioration in average gross operating balance (GOB) to 5.7% operating revenue from estimated 7.3% in 2020 for regions, and to 14.8% operating revenue from estimated 18.5% in 2020 for cities.

In the first half of 2020, both regions and cities reacted to the shortfall in tax revenue by adjusting unnecessary operating expenditure. These cuts, mostly in the area of transfers to subsidiary organizations and repairs, will further limit their expenditure flexibility for 2021.

Historically, Czech RLGs have decreased capital expenditure as a first fiscal measure during an economic downturn. In 2021, we expect capital expenditures to be trimmed to CZK20.1 billion (8% of total revenue) for regions and CZK59.8 billion (18.5% total revenues) for cities - well below the pre-crisis levels at CZK32.2 billion or 13.6% for regions and CZK92 billion or 25.6% for cities in 2019.

In 2020, the central government compensated RLGs' revenue shortfall with a one-off transfer for capital purposes (CZK500 per inhabitant for regions, CZK1200 per inhabitant for cities), however it is unlikely that a similar incentive will be put in place in the next year. Even in absence of state contributions, we expect both regions and cities to post cash financing surpluses around 1% of total revenue in 2021, due to the cuts in capital expense. We expect net direct and indirect debt (NDID) will remain stable at around 10% of operating revenue for regions and 22% for cities in 2021.

Cities are more vulnerable to the tax changes than regions
Operating performances and capital expenditures, % of revenue



2020-21 are Moody's estimates.
Sources: Czech Republic Ministry of Finance and Moody's Investors Service

Endnotes

1 The Chamber of Deputies also approved opposition Pirate MP Mikulas Ferjencik's proposal to raise the basic tax credit from CZK24,840 per taxpayer to the previous year's national gross average wage (CZK34,125). However, the Pirates have stated that their proposal was meant as an alternative to the Prime Ministers' proposal and did not expect both to be passed. Finance Minister Alena Schillerova has asked the Senate to modify the bill and delete the tax credit increase which has an estimated fiscal impact of CZK35 billion.

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