# Credit Outlook

18 March 2021

## NEWS AND ANALYSIS



## CREDIT IN DEPTH



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# US stimulus funding for multiemployer plans is credit positive, but risks persist

On 11 March, US President Joseph Biden signed the American Rescue Plan Act (ARPA) to provide funding for severely underfunded multiemployer pension plans (MEPP). The funding is credit positive for corporations that contribute to the affected plans, all of which plan actuaries project will be insolvent within 15 years. The ARPA funding alleviates the risk that corporations participating in MEPPs would have had to provide additional capital to prevent the plans from becoming insolvent, which would have seriously constrained their future operating cash flow. However, the longer-term uncertainty for plans that are outside the scope of the ARPA relief will persist.

MEPPs are pension plans created through an agreement between two or more employers and a union. The employers are usually in the same or related industries, such as retail (grocery stores) or transportation. Plan funding relies on contributions based on use metrics from sponsor entities. Over the past 20 years, many MEPPs have become dangerously underfunded because of industry consolidation, sponsor bankruptcies and other issues. Although participating companies do not have an on-balance-sheet liability, their union contracts specify a funding contribution formula based on union employee activity.

The funding relief in the new ARPA legislation specifically applies to multiemployer pension plans that qualify, which are those that are considered "critical and declining" for any plan year from the start of 2020 through 2022. A plan is in critical and declining status if its funded percentage is less than 65% and the plan is projected to run out of money within 15 years (or 20 years if there are twice as many inactive as active participants, or if the plan's funded percentage is less than 80%). The most recent MEPP data, a 2018 analysis, showed that 73 of the 1,355 total MEPP plans were designated as critical and declining for the 2018 plan year.

We rate about 120 companies that contribute to MEPPs. Plans eligible for the ARPA relief are only a fraction of those that receive annual cash contributions. Exhibit 1 shows the four largest multiemployer plans that are designated as critical and declining (funded percentage is less than 65%). Plan actuaries project that all of these plans will be insolvent in the next 15 years and would leave behind over $68 billion of unfunded benefits.

Exhibit 1
**2019 multiemployer plan data**
**Four largest plans that are designated as critical and declining**

| | Expected Insolvency | Participants | Plan underfunding* | Funded | Annual benefit payout | Annual employer contributions |
|---|---|---|---|---|---|---|
| Central States, Southeast and Southwest Areas Pension Fund | 2025 | 375,199 | 43,626,979 | 23% | 2,912,062 | 741,717 |
| New England Teamsters & Trucking Industry Pension Fund | 2033 | 72,489 | 15,006,722 | 15% | 613,822 | 355,004 |
| Western Pennsylvania Teamsters and Employers Pension Fund | 2029 | 21,285 | 2,315,350 | 21% | 126,897 | 67,314 |
| Bakery and Confectionery Union and Industry International Pension Fund | 2029 | 106,534 | 8,028,911 | 33% | 625,074 | 158,507 |

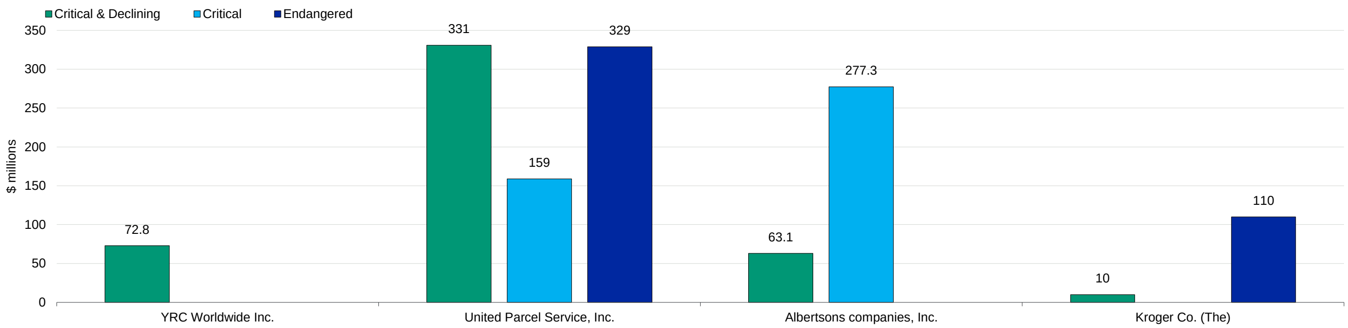
Amounts presented in $ thousands
*Based on RPA 94 liability that uses discount rates more in line with US GAAP
*Source: Moody's Investors Service*

Rated companies that comprise more than 5% of a plan based on total contributions to the plans listed in Exhibit 1 are YRC Wordwide (Central States), United Parcel Service, Inc. (New England Teamsters and Western PA Teamsters), Kroger Co. (Bakery and Confection Union) and Albertsons Companies, Inc. (Bakery and Confection Union). These, with the exception of YRC, all contribute to plans that are either designated as critical (less than 65% funded) or endangered (less than 80% funded). Exhibit 2 shows the relative size of contributions to MEPPs designated as critical and declining for which the legislation creates a short-term solution, versus plans that are also underfunded but currently do not qualify to receive legislative relief.

Exhibit 2

**Selected company contributions**

**Plans designated as endangered, critical and critical and declining**




*Sources: Companies 10-Ks and Moody's Investors Service*

The legislation does not provide assistance for plans not considered critical and declining. Companies that will gain short-term relief from the legislation also participate in other plans that are trending toward, but are not considered, critical and declining because of decreasing funding percentages each year. The legislation does not address systemic issues that will cause plans that are currently classified as endangered or critical to be considered critical and declining after the 2022 assistance cutoff date. For issuers contributing to these critical and endangered multiemployer plans that do not qualify for funding relief, there is continued uncertainty about whether they will be on the hook for future funding shortfalls.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# Cardinal Health's sale of Cordis business enhances liquidity while exiting a challenging business

*Originally published on 12 March 2021*

On 12 March, Cardinal Health Inc. (Baa2 negative) announced that it will sell its Cordis business to private equity firm Hellman & Friedman for approximately $1 billion in proceeds, including working capital adjustments, a credit positive because of the meaningful cash proceeds ahead of a potential opioids litigation settlement. Longer-term, the sale will also reduce Cardinal's investment needs because the Cordis business has high R&D expense and has been underperforming for a number of years. The sale will also limit Cardinal's future litigation exposure within the Cordis business.

The sale will reduce Cardinal's medical segment revenue by $750 million and operating earnings $60-$70 million (2%-3% of total operating earnings). The loss of scale and diversity is immaterial to Cardinal's overall credit profile, particularly in light of some of the challenges in the Cordis business.

The cash proceeds will enhance the company's liquidity amid the uncertainty regarding the timing, structure and ultimate amount of a potential comprehensive opioids settlement. Cardinal's liquidity is already very good, even before the $1 billion of cash proceeds. The company had $3.7 billion of cash and $3 billion of combined unused revolver and A/R securitization facility availability at year-end 2020, at which time the company estimated its pre-tax liability relating to a potential opioids settlement at $6.6 billion.

The companies expect the divestiture's completion during the second half of 2021, roughly six years after Cardinal acquired Cordis from Johnson & Johnson for $1.9 billion. Since it acquired the Cordis business, Cardinal has faced a number of challenges, including those related to international inventory management and sales team issues. While the Cordis business should be higher margin than Cardinal's other businesses, these challenges, along with higher research and development requirements relative to Cardinal's other businesses, have constrained profitability. Cordis' products are generally low-tech minimally invasive cardiovascular devices such as guidewires, sheaths and balloons that are often used alongside highly innovative medical devices. However, these products require more research and development investment than the commodity-like hospital supplies that Cardinal in certain cases also manufactures.

As a result of the transaction, Cardinal will retain existing product liability exposure in the US and Canada tied to Cordis' inferior vena cava (IVC) filter products. Hellman & Friedman will assume the remaining international liability and future claims that may surface in the US and Canada. As of 1 February, the company is a named defendant in 373 product liability lawsuits coordinated in Alameda County Superior Court in California involving claims by approximately 4,800 plaintiffs that allege personal injuries associated with the use of Cordis OptEase and TrapEase IVC filter products. Another 31 lawsuits involving similar claims by approximately 36 plaintiffs are pending in other jurisdictions. As of year-end 2020, Cardinal had accrued $508 million for losses and legal defense costs, net of estimated insurance recoveries, related to the Cordis IVC filter lawsuit. Cardinal has also disclosed that the range of estimated losses could run as high as $990 million, net of estimated insurance recoveries.

Cardinal Health, Inc., headquartered in Dublin, Ohio, is one of the nation's leading distributors of pharmaceuticals and medical supplies. Revenue was approximately $156 billion for 2020.

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# Baidu's Hong Kong secondary listing is credit positive

*Originally published on 15 March 2021*

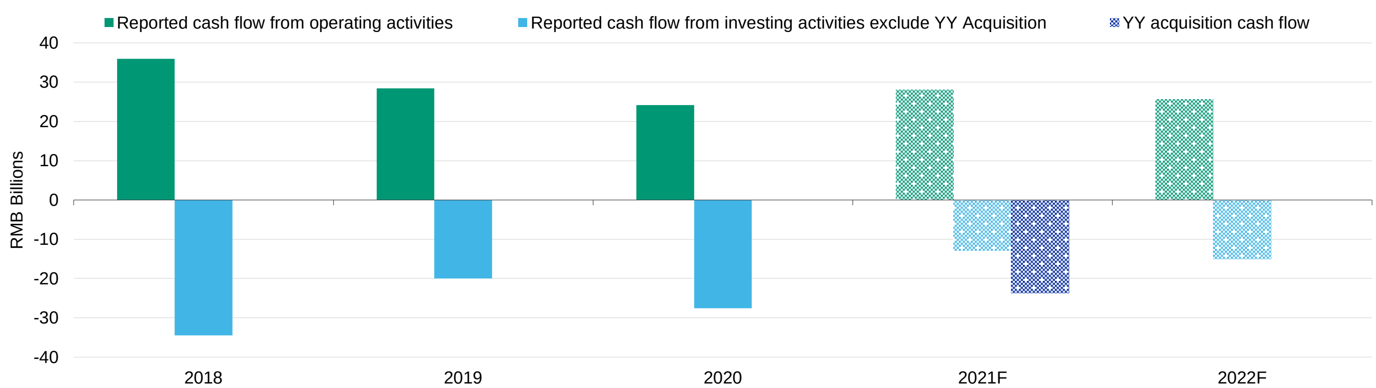
On 11 March, Baidu Inc. (A3 stable) filed with the US and Hong Kong securities commissions and announced its global offering of 95 million Class A ordinary shares. The offering comprises an international offering and a Hong Kong public offering, and could be priced at a maximum of HKD295 ($38.05) per share for retail investors, according to the company's regulatory filings.

The Hong Kong secondary listing is credit positive for Baidu because it broadens the company's already diversified funding channels. Maximum proceeds — assuming it is priced at HKD295 per share, and before considering overallotment — of around RMB24 billion ($3.6 billion) will enhance its equity capital base, help fund future investment requirements and reduce the need for debt. Net proceeds will be used to invest in artificial intelligence (AI) related strategies.

Over the past two to three years, Baidu has invested heavily in AI-related products and services, such as autonomous driving, AI Cloud and the DuerOS voice assistant. While these initiatives added diversification to Baidu's revenue portfolio, they are still in fast-growth phases and require continuous capital input. In addition, iQiyi, Baidu's fully consolidated online video subsidiary, will require heavy investment for content creation and acquisition.

As shown in the exhibit, reported cash used in investment was high around RMB20-RMB34 billion in 2018-20. We expect that total investments will be around RMB15-RMB37 billion annually in the coming two years.

**Baidu will continue to invest heavily in AI-related business initiatives**




Starting 1 January 2020, Baidu adopted the ASU 2019-02 new accounting standard, under which all copyright and licensed content acquisition costs are deducted from operating activities rather than investing activities. This accounting change results in a one-time reduction in retained cash flow, rendering forward estimates incomparable with historical metrics.
On 16 November 2020, Baidu announced it had entered into definitive agreements to acquire JOYY's domestic video-based entertainment live streaming business in China (YY Live), for an aggregate purchase price of approximately $3.6 billion in cash, subject to certain adjustments.
*Sources: Baidu's quarterly result announcements and Moody's Investors Service estimates*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# Spain's new corporate support measures will alleviate banks' asset quality pressure

On 12 March, the Spanish government enacted an €11 billion support package (Royal Decree Law 5/2021) targeting Spanish enterprises and the self-employed in sectors most affected by the coronavirus-induced economic downturn. Unlike most corporate support measures implemented since the onset of the pandemic, this package mainly consists of direct grants to companies and aims to prevent future solvency problems among firms deemed to be viable, a credit positive for banks because it will protect their asset quality.

The package has three main components. The first, with an endowment of €7 billion, consists of grants to enterprises and the self-employed, whose turnover fell at least 30% in 2020 from 2019 levels. Companies must operate in the sectors the package identifies as most severely affected by the pandemic, including food service, accommodation, trade, leisure and transportation.

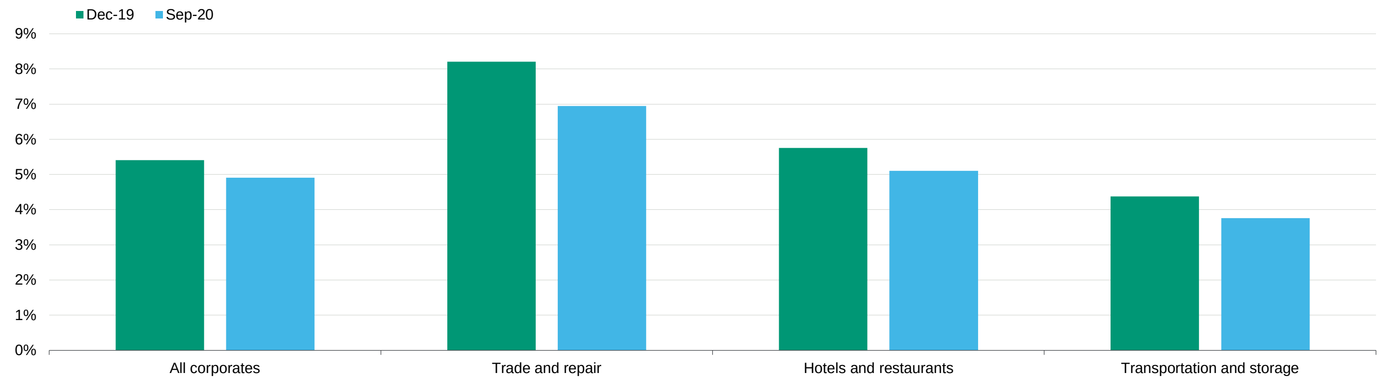
The second component aims to reduce companies' debt burden by providing a number of tools to restructure loans granted under a €100 billion state-guarantee loan program that began in March 2020. The allocation worth €3 billion will cover any expenses related to the restructurings and contemplates measures such as the conversion of loans to equity-like instruments and the partial write-off of such loans.

The third creates a €1 billion fund to recapitalize companies. In addition, the government extended the current ban on new bankruptcy proceedings until year-end 2021 to safeguard companies deemed to be viable while support measures take effect.

Although we assess the package as an overall positive for banks, the potential write-off of state-guaranteed loans would affect them negatively because banks would have to assume the loss on the non-guaranteed portion of the loan (which ranges from 20% to 40%). Nevertheless, we expect the negative effect to be limited because the write-off is designed as a last resort measure (i.e., it can only be implemented once other restructuring measures have been exhausted), and it is likely to be applied when the borrower would have otherwise defaulted. Assuming the government guarantee covers 70% of the affected loans on average, the loss to be absorbed by banks in a worst-case scenario would be around €1.3 billion.

Besides the most immediate benefits for supported companies, the package's enactment signals a strong willingness by the government to continue helping companies until Spain's economic situation normalizes. Since March 2020, the government has implemented several corporate support measures in response to the pandemic's effect on economic activity, and it will likely take additional steps until affected companies can resume their normal operations. Such support measures so far have prevented a deterioration in Spanish banks' corporate loan books, despite a sharp contraction of the Spanish economy in 2020 (Spain's GDP dropped by 11.0% for the year). Problem loan ratios in some of the most exposed sectors even declined in the first nine months of 2020 (the latest data available) compared to the end of 2019 (see exhibit), but we expect that trend to reverse. The trade, hospitality and transportation sectors represented 28% of Spanish banks' corporate loan books as of the end of September 2020.

Spanish banks' problem loan ratio by corporate segment




*Source: Bank of Spain*

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# Swedish resolution authority plans to maintain high requirement for bail-in-able debt, a credit positive

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On 12 March, the Swedish National Debt Office (SNDO), the resolution authority, said that the Ministry of Finance's proposed revision to the Swedish resolution law (2015:1016) will allow the SNDO to continue to set high minimum requirements for own funds and eligible liabilities (MREL) for all nine of the country's systemically important banks (SIBs). The proposal specifies that the nine SIBs must comply with MREL no later than 1 January 2024 by building up sufficient volumes of equity and liabilities, in a linear manner, that are fully subordinated to senior unsecured debt. The regulation will facilitate effective bank resolution through maintaining large enough buffers of liabilities to bail-in and recapitalise each of the nine SIBs. This regime appears more comprehensive than that applied to Euro area banks, where a cap on subordination (of 27% of Total Risk Exposure Amount) applies to the top tier of banks.

The SNDO's power to require full subordination of MREL is credit positive for senior creditors of Sweden's nine SIBs. It will require them to issue roughly SEK200 billion of non-preferred senior debt in 2021-23, in line with our previous expectations. Because the non-preferred senior debt is subordinated to senior unsecured debt, it will add substantial protection for senior bondholders.

Sweden's SIBs are Svenska Handelsbanken AB (Aa2/Aa2 stable, a2[1]), SEB AB (Aa2/Aa2 stable, a3), Swedbank AB (Aa3/Aa3 stable, baa1), Swedish Export Credit Corporation (Aa1/Aa1 stable, a2), SBAB Bank AB (A1/A1 stable, baa1), Lansforsakringar Bank AB (A1/A1 stable, baa1), Skandiabanken AB (A2 stable, a3) Landshypotek Bank AB, and Sparbanken Skåne AB.

While the Bank Recovery and Resolution Directive 2 (BRRD2) will deliver increased flexibility for the SNDO to set lower MREL and subordination requirements than currently specified, the SNDO's communication clarifies its intention is to maintain a high required level of subordinated liabilities for all nine banks.

Following the introduction of the new European banking package in early 2019, the ability of the SNDO to maintain a high required level of subordinated debt for all nine banks under the revised BRRD framework appeared uncertain. The proposed revision to resolution law from the Ministry of Finance and the SNDO's proposed regulation indicates that the Swedish authorities can maintain their conservative approach to creditor protection.

Both the law's revision and the regulation for SNDO's requirements come into effect on 1 July. Since the methodology for calculating the requirements for each bank individually will change, the exact volume that each bank needs to issue may change, but our expectation is that the requirements will be similar to today for most banks. The SNDO has announced its intention to communicate a new methodology in the second half of 2021, and present individual requirements in December 2021, updating them annually.

Because of the planned issuance of senior non-preferred debt, we already anticipate a high level of support to depositors and more senior bondholders. This is reflected in the loss given failure component of our ratings, with the number of notches of rating uplift depending on the liability structure of individual banks.

## Endnotes

1 The ratings shown are the banks' deposit rating, senior unsecured debt rating (where available) and Baseline Credit Assessment

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# Democratic Republic of Congo cuts key rate, supporting banks' profitability

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On 12 March, the Democratic Republic of the Congo's (DRC, Caa1 stable) central bank lowered its benchmark interest rate to 15.5% from 18.5%. The 300-basis-point rate decrease is credit positive for DRC banks because it will decrease their cost of meeting regulatory reserve requirements in the local currency, the Congolese franc, which will support their profitability this year.

The central bank's benchmark interest rate has a limited effect on banks' deposit gathering and lending activities because the rate only influences franc-denominated assets and liabilities. In DRC, 95% of loans and 87% of deposits were denominated in foreign currencies (predominantly in US dollars) as of June 2020.

Per local regulation, DRC banks' accounts at the central bank must include a minimum amount of local currency reserves, which are calculated as a proportion of each bank's deposit base. Because DRC banks primarily fund themselves through foreign-currency deposits, but must meet reserve requirement in the local currency, they typically buy the required francs from the central bank or in the interbank market at a rate influenced by the central bank's benchmark interest rate. Consequently, a lower benchmark rate decreases banks' costs of buying francs to satisfy their reserve requirement. The reserve requirement ratio for DRC banks is 13% of their foreign-currency demand deposits and 12% of their foreign-currency time deposits. Local-currency deposits have no reserve requirement.

The benchmark rate decrease follows gradual stabilisation of the Congolese franc against the US dollar, and follows a 1,100-basis-point increase in the key policy rate in August 2020. Additionally, the inflation rate in commodity-exporting DRC has stabilized amid gradually recovering global economic activity (including in China) and higher commodity prices. The DRC's large exposure to China, which purchased 42% of DRC goods exports in 2019, leaves DRC's economy directly exposed to Chinese economic trends, which drive the demand for commodities and their prices.

The Congolese franc depreciated around 0.7% against the US dollar so far this year, compared to a 17.5% depreciation in 2020 amid pandemic-weakened global economic activity and lower commodity prices, particularly in the first half. We estimate DRC's inflation rate was 17.1% last year, but with diminished pressure on the local currency, the February inflation rate was 0.3% and the central bank forecasts that in unchanged conditions the annual inflation rate will be 4.7% this year.

The coronavirus pandemic significantly weighed on DRC's economic activity in 2020, reflecting the country's high vulnerability to external shocks and terms-of-trade shocks because of its reliance on commodity exports and external funding. Minerals and metals account for more than 80% of DRC's exports. However, we expect DRC's real GDP growth to increase to 4.5% in 2021 and 6.0% in 2022, from around a 3.0% contraction in 2020.

We expect DRC banks' underlying financial performance to remain broadly sound over the next 12-18 months. The banks have deposit based funding and strong liquid resources. The banks' problem loan coverage and sound capitalisation will help moderate asset quality deterioration from the economic slowdown last year. We estimate that banks' underlying profitability in 2020 was lower than in 2019, but we expect a recovery in 2021 supported by increased commodity prices.

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

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# California directs auto insurers to refund additional premiums to policyholders

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On 11 March, the California Department of Insurance (DOI) issued bulletin 2021-03, directing California auto insurers to provide additional premium relief to policyholders because 2020 auto insurance premium reductions were not commensurate with lower accident frequency during the pandemic. The DOI directed auto insurers to report by 30 April how they will return additional premiums to policyholders.

The order will likely reduce profitability for auto insurers with significant market share in California (see Exhibit 1) because they may be required to return additional premiums to California motorists.

Exhibit 1

**Top 10 California personal auto insurers, 2019**

| Company | Lead Company IFS Rating/Outlook | California Personal Auto Market Share | California Personal Auto DPW, $ billions | California Personal Auto % of Total Business | Policyholders' surplus, $ millions |
|---|---|---|---|---|---|
| State Farm | NR | 13% | 3,969 | 6% | 116,232 |
| Farmers | A2/Neg | 10% | 3,255 | 16% | 6,220 |
| GEICO | Aa1/Sta | 10% | 3,235 | 7% | 216,581 |
| AAA | NR | 9% | 2,757 | 61% | 8,104 |
| Allstate | Aa3/Sta | 9% | 2,748 | 8% | 19,887 |
| Mercury | A2/Sta | 8% | 2,416 | 69% | 1,346 |
| CSAA | NR | 7% | 2,173 | 53% | 3,578 |
| Progressive | Aa2/Sta | 5% | 1,593 | 4% | 13,670 |
| USAA | Aaa/Neg | 5% | 1,444 | 6% | 30,476 |
| Kemper | A3/Sta | 4% | 1,182 | 38% | 1,371 |
| **Top 10 CA Personal Auto** | | **80%** | **24,772** | **10%** | **417,465** |
| **Total CA Personal Auto** | | **100%** | **31,122** | **4%** | **866,615** |

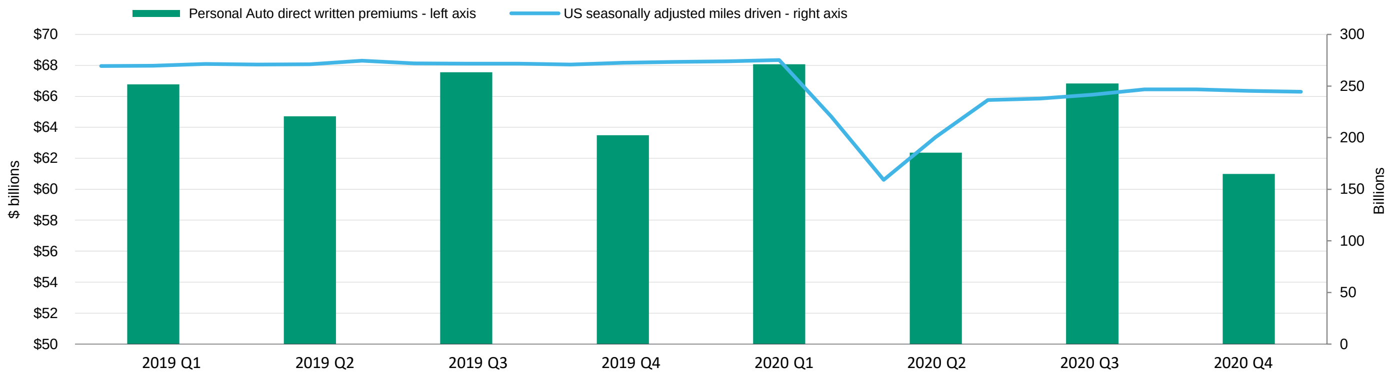
Insurance financial strength ratings apply to the rated insurance subsidiaries of the company. Information based on statutory combined financial statements as of 31 December 2019.
*Sources: SNL Financial LC (contains copyrighted and trade secret materials distributed under license from SNL, for recipient's internal use only) and Moody's Investors Service*

In April, following “stay-at-home” orders, DOI Commissioner Ricardo Lara ordered auto insurers to return a percentage of premiums to drivers through direct payments, credits, and future premium offsets. In the DOI's recent review of the top 10 insurance groups, which have an 80% share of the California personal automobile insurance market, the DOI found that insurers should have refunded about 17% of premiums for the seven-month March-to-September period given lower accident frequency, but insurers only refunded about 9% of auto premiums.

Because of the coronavirus pandemic, miles driven declined precipitously starting in March 2020 (see Exhibit 2), partially recovering later in the year. Consequently, many personal auto insurers returned portions of their premiums to customers beginning in second-quarter 2020. Miles driven declined 13% in 2020, compared with 2019, and remain below pre-pandemic levels. According to the Insurance Information Institute, US auto insurers announced more than $14 billion of premium returns as of June 2020. We expect that Commissioner Lara’s directive could also lead other state insurance departments to seek additional premium returns.

Exhibit 2

**Miles driven and auto premiums declined starting in March 2020**

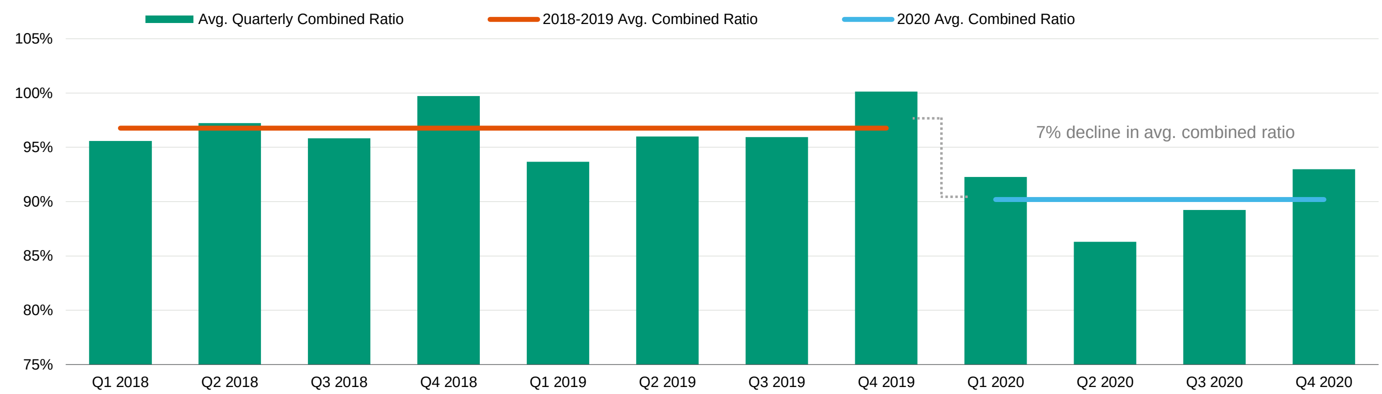



*Sources: U.S. Department of Transportation and SNL Financial L.C. (contains copyrighted and trade secret materials distributed under license from SNL, for recipient's internal use only)*

Despite the premium returns, insurers reported unusually low combined ratios (incurred losses and expenses as a share of premiums) for 2020 compared to 2019 (see Exhibit 3) because of the decline in miles driven and lower accident frequencies during the pandemic. Driving activity and claim frequencies are off their lows of April 2020, but remain below prior-year levels.

Exhibit 3

**Significant decline in auto combined ratio for 2020**




Includes GEICO, Progressive, Allstate, Travelers, Kemper, Hartford, Horace Mann and Selective

*Sources: Company reports and Moody's Investors Service*

The benefit of lower claim frequency was partly offset by higher claim severities, caused by higher driving speeds on roads with less traffic. In January, the National Highway Traffic Safety Administration (NHTSA) reported its preliminary estimate that US traffic fatalities for the first nine months of 2020 rose 4.6% to 28,190 from a year earlier, despite the decline in miles driven. In addition, the pandemic is resulting in more late reported claims and prolonged settlement periods, adding uncertainty for auto insurers. Increases in accident severity are a risk for US personal and commercial auto insurers, particularly as the economy gradually recovers and courts reopen.

For 2020, personal lines writers generally reported higher earnings, benefiting from reduced auto claim frequency, while commercial and specialty writers reported lower net income, driven by significant claims from catastrophes, including weather-related and coronavirus losses. As leading carriers continue to generate favorable combined ratios, even in a recovering economy with rising claim frequencies, we expect increased competition and rate reductions in personal auto insurance in the quarters ahead.

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# Successful reference rate switch of Libor-linked mortgage loans sets UK precedent for RMBS market

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On 16 March, Kensington Mortgage Company Limited, a UK mortgage provider, delinked Gemgarto 2018-1 plc (Gemgarto) from its tie to three-month sterling Libor (Libor). Gemgarto is a UK residential mortgage-backed securitisation (RMBS) transaction backed by owner-occupied residential mortgage loans originated mostly in 2018 and with interest rates originally tied to Libor. Amendments made by the issuer have achieved full future delinkage from Libor across the asset, liability and hedge sides of Gemgarto, which matures in September 2065.

The delinkage is credit positive because it avoids the credit risks of continued Libor linkage as Libor is phased out. Libor will cease to exist in its current form by year-end, the ICE Benchmark Administration said earlier on 5 March. Gemgarto had multilayered exposure to Libor through its swaps, note coupons and securitised mortgage loan agreements. The rate at which the entire loan pool would adjust or link to at the end of each loan's initial fixed-rate period was explicitly tied to Libor.

Until recently, there has been limited progress in migrating mortgage loan contracts with a hard-coded link to Libor to alternative rates in the UK mortgage market. The Gemgarto transition sets a market precedent by achieving a switch to an alternative reference rate from a hard-coded Libor-linkage in an already securitised mortgage portfolio. And, given that ICE's announcement will likely accelerate the pace of replacing Libor reference rates in securitisation transactions, it will likely pave the way for similar conversions.

The UK RMBS market is exposed to Libor and has a significant stock of legacy mortgage loan portfolios that were originated when Libor was a widely used reference rate for pricing. During Libor's wind-down and complete cessation, cash flow mismatches between securitised loan agreements and other liabilities and costs in similar transactions are a potential risk, a credit negative. Indeed, around 21% of the UK RMBS we rate had both limited mitigants against Libor cessation risk and multilevel Libor exposure as of September 2020.

Since 2019, most UK primary securitisations have adopted the daily compounded Sterling Overnight Interbank Average Rate (Sonia) as the new standard reference rate, in place of Libor. And in recent years, most UK securitisations that still referenced Libor began introducing specific mitigants to Libor cessation risks, such as the inclusion of fallback reference rate language for the notes and hedge agreements. The market has also started to address Libor transition risks in note coupons over the past year, as demonstrated by several successful transitions to Sonia.

Gemgarto's changes allow its servicer to gradually migrate the borrowers to an alternative reference rate and away from Libor. The servicer's stated base rate is currently tied to the Bank of England base rate. Included in Gemgarto's amendments, the notes' reference rate was updated to compounded daily Sonia from Libor, while the floating leg of the issuer's swap was amended to return daily compounded Sonia instead of Libor. These changes enable the issuer to limit potential future cash flow mismatches, a credit positive.

Aiding the switching process were clearly drafted mortgage loan contracts that specifically allowed the servicer to substitute the reference rate upon Libor cessation, as well as certain industry and legislative initiatives such as the Libor Task Force and the Financial Services Bill.

Older securitisations containing mortgage loans with less flexible contractual language may not be as easy to transition to a new reference rate. Also, the success of any such endeavour is facilitated by having proactive and engaged transaction counterparties, noteholders, servicers and sponsors.

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## CREDIT IN DEPTH

# Light vehicle sales recovery is underway, but regionally uneven

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» **Our sector outlook remains stable on a continued recovery of vehicle sales.** The final quarter of 2020 was solid, so the full-year drop in global light vehicle sales of 14% was more moderate than we had expected (-16%). This was mainly because of China, which was close to stable (-1.9%) compared with pre-pandemic levels in 2019. By contrast, Western Europe was down -24%, making it the worst performing major auto market in 2020.

» **Recovery will continue, but remain uneven.** We expect global light vehicle sales will continue to recover in 2021, in an overall economic environment of around 5.3% real GDP growth in the G-20 economies (see our macroeconomic outlook published in February). The recovery in the auto sector will, however, be uneven and faces short-term headwinds like a shortage of semiconductors, which might diminish production by around 2% this year hurting automakers around the world. Persistent virus fears and delayed vaccination processes in some regions, including Germany, are the main risks to a recovery.

» **Reaching pre-downturn levels will take until about 2025.** We continue to expect it will take until mid-decade to fully recover to pre-crisis levels of 95 million units. This reflects that the auto industry already entered a cyclical downturn in 2019, after nearly a decade of growth. Moreover, the pace of recovery will suffer from gradually expiring economic stimulus measures.

» **Slow climb back in 2021-22 on chip shortage, slow vaccine roll-out.** We now expect 2021 global vehicle sales to grow 7% to 83 million units, slightly lower compared to our previous expectation of 7.7%. This lower figure reflects the headwinds, especially in the first half of this year because of the microchip shortage. Assuming last year's industrial production lockdowns of about 6 weeks in many regions will not be repeated this year, our recovery expectation remains cautious. For 2022, we expect further growth of around 6% to 88 million units. This reflects further production normalization and continued demand recovery.

» **Recovery potential is particularly high in Europe; China and North America will remain robust.** After the sharp drop in 2020, we expect a 11% recovery in Western Europe for 2021, with double-digit percentage growth in France, Spain and the UK. Germany, which took less of a hit in 2020, will grow only around 8% this year. China, the world's largest auto market, will return to growth, after three consecutive years of decline. For the US, as well as North America overall, we expect around 5% growth this year (see Table).

» **What could change our outlook.** We would consider changing our outlook back to negative if we expect a contraction in global light vehicle sales, a slowdown in organic revenue growth to below 2.5% and negative free cash flow. We could change our outlook to positive if we expect aggregate organic revenue growth and median EBITA growth in excess of 5%, accompanied by solid free cash flow generation. However, we would only move to a positive outlook in a more stable business environment that would create better visibility for a sustainable strengthening of credit metrics above and beyond pre-crisis levels.

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# China's Five-Year Plan highlights cautious balance between growth, risks and stability

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On 11 March, China (A1 stable) concluded the annual meetings of its top legislative and advisory bodies, the National People's Congress (NPC) and the National Committee of the Chinese People's Political Consultative Conference. During the meetings, better known as the two sessions, the government revealed a growth target of above 6% for 2021, and fleshed out its policy focuses for the years beyond with the publication of its draft Five-Year Plan.

**Growth will continue to shape economic policy, with greater focus on quality** The shift toward structural issues supports sovereign credit quality, although fiscal pressures may rise. The conservative growth target will limit pressure on regional and local governments (RLGs) to stimulate growth. Large, targeted investment will support corporate credit.

**Gradual normalization of fiscal and monetary policy supports recovery while avoiding excesses** While the work report indicates a continued moderate rise in general government debt, higher spending on innovation and infrastructure would be credit positive for the sovereign if it raised productivity. The scaling-back of stimulus will add to credit pressures for less resilient RLGs. Meanwhile, the likely gradual rise in interest rates as the economy recovers will have a mixed credit impact on banks.

**Innovation and R&D are key priorities to achieve technology self-reliance and supply chain security** China's emphasis on domestic demand and supply is likely to spur private consumption and investment, while promoting industrial upgrade and technological progress could support productivity growth, mitigating pressures on potential growth from an aging population. The focus on R&D and innovation should support strategic industries.

**Focus on clean energy and environmental protection targets peak carbon by 2030, reduction in carbon intensity** While new goals will drive growth potential for renewables and electric vehicles and help achieve sustainable economic growth, regions and sectors that rely heavily on traditional resources and resource-exhausted areas are likely to face significant challenges. Investment in related infrastructure and equipment and the costs of industrial transition could also pose a burden for the government and SOEs.

**Commitments to boost household income, strengthen social safety net aim to improve living quality and drive domestic consumption** The focus on incomes and increasing urbanization could have significant credit-positive implications for the sovereign. For RLGs, however, the focus on strengthening the social safety net is likely to create greater budgetary pressures over the medium term. In the corporate space, these policies could create new opportunities for providers of education and basic services.

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## Editors

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