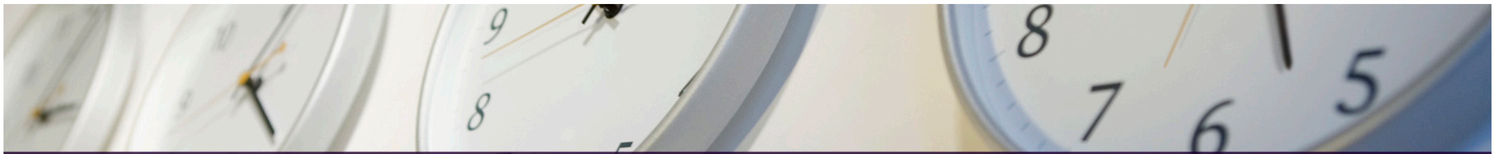

Credit Outlook

4 November 2021

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Steadying economic activity, supported by progress in vaccinations against COVID-19, will drive enhanced credit quality of debt issuers overall. But leverage risks will remain high.

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EU suspends tariffs on US whiskey, a credit positive for Brown-Forman

Originally published on 01 November 2021

On 30 October, the G20 summit announced an agreement to suspend the 25% tariffs on US bourbon and whiskey sold in the EU. The suspension, beginning in January 2022, is credit positive for Brown-Forman Corporation (A1 stable), the largest American-owned spirits and wine company. Developed international markets contributed close to 30% of Brown-Forman's total sales and we estimate that EU markets account for about two thirds of that amount in fiscal 2021, which ended 30 April.

The tariffs have been costly for Brown-Forman, and CEO Lawson Whiting estimated the effect on gross profit at about $70 million per annum (including EU, UK and others) because the company had not fully passed on the incremental tariff costs to its European consumers in pricing. Like all consumer products companies, inflationary pressure, including rising input and transportation costs, are pressuring Brown-Forman's gross margin, so the suspension of the tariffs will be particularly helpful given these cost headwinds. However, management stated that some of the benefit would be reinvested to support the business and not all fall to the bottom line.

The EU is the largest export market for American whiskies, according to spirits industry newsletter Shanken News Daily, and the tariffs prompted nearly a 40% decline in the whiskey category in the EU between 2018 and 2020. The EU in 2018 implemented tariffs on whiskeys and other US exports in response to the US imposition of tariffs on steel and aluminum imports, and will suspend the tariffs in response to the US also lifting some tariffs on European steel and aluminum. Importantly, the agreement avoids a further increase of the tariffs to 50% from 25% that could have been implemented in December had a deal not been reached.

The UK, which was part of the EU in 2018, still retains a 25% tariff on US whiskey. It is not clear when this residual tariff will be lifted, but the UK is reviewing its retaliatory tariffs. The UK comprised about 6% of Brown-Forman's total sales in fiscal 2021.

Brown-Forman's ratings remain supported by healthy credit metrics, good geographic diversification, strong operating margins and ownership of the Jack Daniel's brand, which is the world's largest American whiskey. The business generates solid margins and stable free cash flows despite modest sensitivity to discretionary consumer spending because of its portfolio of premium brands that have considerable pricing power and consumer demand.

We expect that Brown-Forman will generate mid-single-digit revenue and earnings growth going forward as its business recovers from COVID-related pressure and as spirits consumption expands. The rating is constrained by a relatively small scale and limited product diversification with a meaningful concentration of sales and profits from Jack Daniel's. Brown-Forman historically maintains conservative financial policies. However gross debt to EBITDA leverage is elevated following a one-time special dividend in 2018 after US tax law change and the unprecedented pandemic-related effects. Failure to improve credit metrics or further debt-funded shareholder distributions before metrics improve could result in negative rating pressure.

Brown-Forman is best known for its Jack Daniel's brand, on which it relies despite growing diversification in its product portfolio. Other well-known brands include Finlandia vodka, el Jimador and Herradura tequilas, Woodford Reserve and Old Forester bourbon whiskies, and Sonoma-Cutrer wines. Brown-Forman products are sold in more than 170 countries with the largest operations in the US, the UK, Australia, Mexico, Germany, France, and Poland. Brown-Forman is a publicly traded but family-controlled company, with the Brown family owning more than two-thirds of its voting stock and over 50% economic interest. Annual net sales were around $3.6 billion as of the last 12 months that ended July 2021.

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CMA's acquisition of Fenix Marine Services is credit positive

Originally published on 03 November 2021

On 3 November, container shipping company CMA CGM S.A. (Ba3 positive) announced its intention to acquire all of the shares in container terminal operator Fenix Marine Services (FMS) for an enterprise value of $2.3 billion from an infrastructure fund affiliated with Swedish investment company EQT. CMA holds 10% of the shares after selling a 90% stake to EQT in 2017. CMA will pay approximately $1.8 billion in cash for the shares, and the remainder of the enterprise value consists of existing debt. The ultimate capital structure of the terminal has yet to be disclosed.

We view CMA's acquisition of FMS as credit positive considering the strategic value of the acquired terminal, which protects and potentially enhances CMA's market position in the US because of the secured access to the US infrastructure and global supply chain. CMA is likely to realize cost savings on container handling services from owning the asset because the company already contributes around 70% of FMS' annual volume (99% including Ocean Alliance partners). Furthermore, the terminal has potential for expansion, which would allow additional CMA volume.

Although the acquisition will lead to a significant cash outflow, depending on the funding structure, it is likely to be funded with the free cash flow that CMA generated in past quarters amid strong market conditions in the global container market. CMA's Ba3 rating and positive outlook are unchanged despite the cash outflow and slight dilutive effect on credit metrics, reflecting the company's continued strong operating performance, free cash flow generation and debt reduction.

Based in the San Pedro Bay in Los Angeles, FMS operates the second-largest container terminal in the Port of Los Angeles, a port that handles 17% of all US imports annually. The terminal spans 292 acres and features deep berths and on-dock rail connections supporting large vessels. It has an annual capacity of 2.5 million 20-foot equivalent units (TEUs).

Furthermore, unused land in the terminal has the potential to enable a 40% increase in capacity if developed to expand the terminal. FMS benefits from a long-term concession with the Los Angeles Harbor Department, CA (Aa2 stable) through 2043.

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Coke's purchase of remaining BODYARMOR stake is credit positive despite high price tag

Originally published on 02 November 2021

On 1 November, The Coca-Cola Company (Coke, A1 stable) announced that it will spend $5.6 billion to purchase the remaining 85% of BODYARMOR that it does not already own, largely to be funded with cash. Owning BODYARMOR is credit positive for Coke despite the high purchase price because it adds full control of the fast-growing sports drink to the company and does not materially affect gross leverage since it will be largely funded with cash on hand. Coke's A1 senior unsecured rating is not affected because the deal will be cash financed and enhances profitability and growth opportunities for Coke and certain of its bottlers.

According to the company, BODYARMOR is currently the No. 2 sports drink in the US in measured retail channels, growing at about 50% in the past year to more than $1.4 billion in retail sales, up from about $400 million in 2018. Coke purchased a 15% stake in 2018 for an undisclosed amount with a path to full ownership at a predetermined discount. At that time, Coke moved BODYARMOR distribution into its own US bottling system; the brand had previously been distributed by the Keurig Dr Pepper system. The move helped to fuel growth in the brand and contributed to the profitability of domestic bottlers. While the company has not stated any plans for international distribution, there is significant potential upside should it decide to put the brand into its international bottling network, as it did so successfully with Monster.

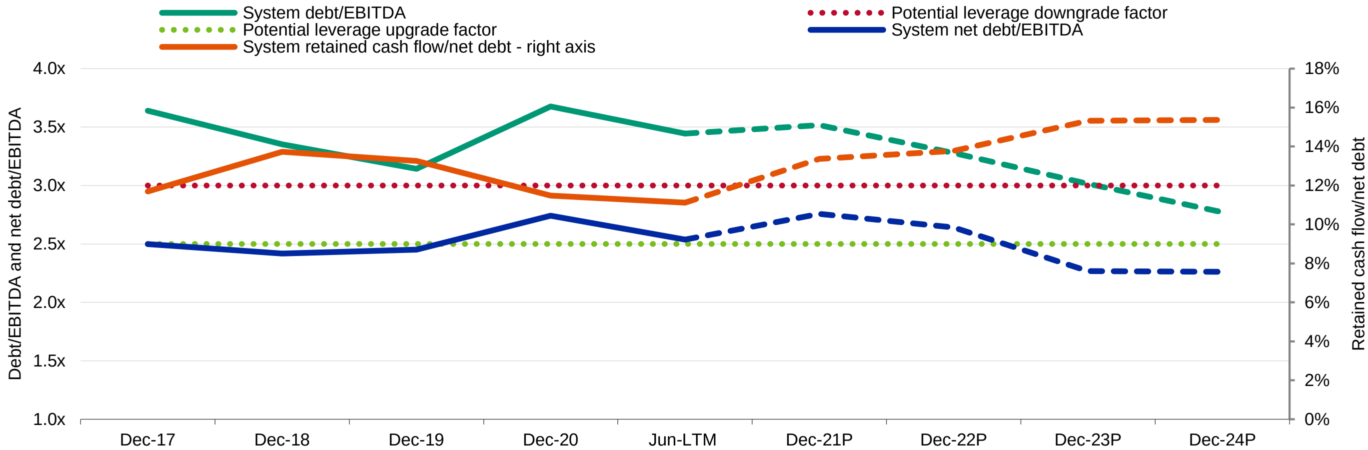
Coke had cash, short-term investments and marketable securities totaling more than $14.8 billion at the end of its third quarter. The company's cash position benefited from strong reported cash from operations in 2021 of more than $9 billion year to date, up about 48% from the prior year as the company began to recover from the effect of global shutdowns in 2020.

The company also generated almost $2 billion from asset sales, largely related to monetization of its stake in Australian based bottler Amatil after Coca-Cola Europacific Partners acquired the bottler. Because of global shutdowns, lack of consumer mobility and a heavy dependence within the Coca-Cola system on on-premise or away-from-home consumption, the Coca-Cola system was severely challenged in 2020, with Coke and many of its bottlers posting EBITDA declines despite significant cost cuts.

Coke has among the largest exposures to on-premise consumption among the beverage companies we rate, with 40%-50% of pre-pandemic revenue generated away from home. As EBITDA fell during the pandemic, leverage increased, but we expect that it will continue to improve as EBITDA recovers. Because of the EBITDA declines, system debt to EBITDA leverage spiked to about 3.7x as of year end 2020 (about 2.7x on a net debt to EBITDA basis because of cash kept on hand to bolster liquidity). System leverage had declined to about 3.4x on a gross basis and 2.5x net debt to EBITDA by the end of second quarter.

We expect year-end debt to EBITDA leverage for the Coca-Cola system to remain about the same as it was in the second quarter, incorporating the BODYARMOR and Amatil acquisitions but also continued strengthening EBITDA performance during he back half of 2021 . We expect system debt to EBITDA leverage to decline to about 3.0x or below by 2023 (see exhibit).

We expect Coke's leverage metrics to improve with earnings growth
Left scale ties to leverage metrics, right scale ties to retained cash flow/net debt



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

Coca-Cola's credit profile reflects its leading position in the global carbonated soft drink industry. The system has a highly diverse global network, a strong and growing non-carbonated portfolio and unrivaled distribution, but these factors are tempered by moderately high system leverage amid the pandemic, including the loss of on-premise sales for much of 2020. Reduction in leverage from expected earnings growth as on-premise venues reopen and volume recovers will be partially offset by Coca-Cola Europacific Partners' (CCEP) acquisition of Amatil in 2021.

Additionally, Coke faces potential tax payments associated with a long-standing US Internal Revenue Service (IRS) lawsuit. We have included as debt in our forecasted metrics a potential near-term $4.6 billion liability (2020 10K) that could result if the loses the IRS case and an additional $9 billion potential payout in 2024 in the event an appeal goes against the company. These amounts add to somewhat more than the $12 billion that Coke has estimated, allowing for additional fees or interest and not assuming offsets. Should the lawsuit go in Coke's favor the company and system will be in a significantly stronger position than indicated by these leverage metrics that include the potential payments.

Coke has a publicly stated net debt to EBITDA target of 2.0x-2.5x (it was 1.87x as of third-quarter 2021 based on the company's calculation). While our base case does not assume asset sales, the planned initial public offering of the African bottling operations, along with other possible bottling investment divestitures, could accelerate deleveraging.

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Worthington's planned acquisition of Tempel Steel is credit positive

On 1 November, Columbus, Ohio-based Worthington Industries, Inc. (Baa3 stable) announced its definitive agreement to acquire Tempel Steel for around $255 million in cash plus the assumption of certain liabilities. Worthington expects to fund the acquisition with excess cash from its balance sheet.

The acquisition is credit positive for Worthington, a diversified metals manufacturer that processes steel, produces pressure cylinders, steel tanks and specialized tools for customers in the automotive, construction, industrial, consumer products, agriculture, heavy truck and alternative fuels sectors. Acquiring Tempel, which manufactures highly engineered electrical steel laminations used in electric motors, transformers and generators, would broaden Worthington's steel products offerings and presents cross-selling opportunities with its existing automotive customers.

It would moderately reduce Worthington's reliance on joint venture income, which contributed about 40% of its total adjusted EBIT in fiscal 2021 (which ended May 2021). Management expects the acquisition will be accretive to earnings.

Tempel has about 1,500 employees and operates five manufacturing facilities in the US, Canada, Mexico, China and India. The company serves end markets that are highly exposed to decarbonization and energy efficiency improvement efforts, including renewable energy, electric vehicles and utility infrastructure. Tempel generated net revenue of about $377 million and adjusted EBITDA of $35 million, excluding estimated inventory holding gains during the last 12 months that ended September 2021.

Worthington had $399 million of cash as of 31 August, which was bolstered by its sale of all of its shares in Nikola Corporation in fiscal 2021 (ended May 2021). Worthington provided start-up seed capital of approximately $2 million to Nikola in 2015 and sold all of its roughly 19 million shares for approximately $634 million. The sale proceeds enabled Worthington to complete a few strategic acquisitions and moderately reduce its reliance on joint venture income while returning cash to shareholders without raising incremental debt. The company chose not to pay down any of its debt, but it has no material debt maturities until August 2024.

Worthington produced $478 million in adjusted EBITDA in fiscal 2021 versus $337 million in fiscal 2020, benefitting from higher volume and improved productivity versus the COVID-19 affected period as well as improved metal spreads and steel inventory holding gains in its Steel Processing segment. Worthington will benefit in fiscal 2022 from continued high steel prices early in the year along with increased volume and earnings from acquired businesses.

However, its operating performance may weaken as the year progresses if steel prices decline from the current extremely high and unsustainable level with hot rolled coil prices stabilizing near the highest level ever recorded going back to 1960. If steel prices decline, it would result in strong cash flows for the company as working capital investments are reduced and its credit metrics will likely remain strong for its Baa3 rating with the leverage ratio (debt/EBITDA) around our upgrade guidance of less than 2.0x. Its ratings upside will remain limited by its moderate scale and reliance on joint venture income. Nevertheless, a ratings upgrade could be considered if the company materially reduces its reliance on joint venture income.

Worthington Industries is a diversified metals manufacturing company that operates 22 wholly owned facilities worldwide and holds equity positions in nine joint ventures that operate 50 additional facilities. Worthington's business segments include Steel Processing (68% of LTM sales), Consumer Products (15%), Building Products (12%) and Sustainable Energy Solutions (5%). Worthington generated revenue of about $3.6 billion for the twelve months ended 31 August.

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Takeda Pharmaceutical's planned share buyback is credit negative despite minimal effect on leverage

Originally published on 01 November 2021

On 28 October, Japan's Takeda Pharmaceutical Company Limited (Baa2 positive) announced second-quarter (ended 30 September) results and a planned share buyback of up to ¥100 billion between 2 November and 29 April 2022. The share buyback is credit negative because it will reduce funds that could otherwise service debt obligations.

However, because the buyback will be funded with cash, Takeda is unlikely to incur additional debt and the effect on leverage will be minimal. Takeda has excellent liquidity, with around ¥608 billion of cash on its balance sheet as of first-half fiscal 2021. The ¥100 billion buyback equals around 2.2% of total shares outstanding, excluding Treasury shares, as of 28 October.

Takeda said that the buyback is an opportunity to purchase its shares at a discount since management views the current share price as a substantial discount to underlying value. Takeda also said the buyback points to confidence in the business strategy and commitment to delivering value to shareholders. Takeda's share price has recently underperformed the overall Japanese equity market, especially after the 5 October suspension of its phase 2 trials for TAK-994 because of liver-safety concerns. TAK-994 is one of several drugs being developed within Takeda's Orexin franchise.

The company said that the share buyback will not affect its deleveraging plans and we do not expect it to be a major setback. The company is still on track for leverage (as measured by adjusted net debt/EBITDA) of around the low 2x range by the end of fiscal 2023. The company also confirmed it will maintain its existing dividend policy: it has paid a flat ¥180/share dividend annually since the January 2019 acquisition of biopharmaceutical company Shire plc. However, Takeda has changed its capital allocation policy wording alongside the buyback announcement and will now allow for share buybacks, when appropriate. Since its acquisition of Shire, Takeda has not conducted any major share buybacks.

To reach its leverage target, Takeda divested over $12.9 billion (pre-tax) in non-core assets, maintained a flat dividend since 2019 and initiated several early redemptions. The redemptions included prepayment of a term loan from the Japan Bank for International Cooperation (A1 stable) in June 2021 ($2 billion); and early redemptions of senior unsecured bonds in May 2021 ($200 million) and August 2021 (€1.5 billion). These deleveraging actions far outweigh the cost of the buyback.

We changed Takeda's outlook to positive from negative on 27 September to reflect the company's significant debt reduction since the Shire acquisition, which significantly increased free cash flow generation in support of deleveraging. We expect the company to reduce its leverage to the mid 3x range by the end of fiscal 2022. We project free cash flow of around ¥300 billion yearly, or ¥500 billion-¥600 billion excluding dividends.

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China's implementation of total loss-absorbing capacity requirement will be credit positive for the largest banks

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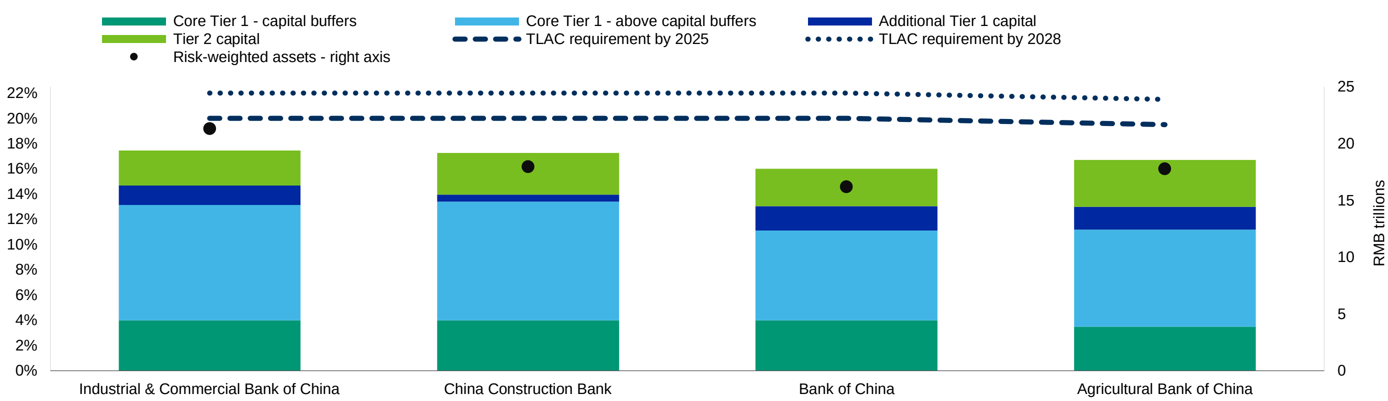
On 29 October, the People's Bank of China, the China Banking and Insurance Regulatory Commission and China's finance ministry finalized a regulation on the implementation of total loss-absorbing capacity (TLAC) for China's global systemically important banks (G-SIBs).[1] The regulation, which will be effective from 1 December 2021, is credit positive for Chinese G-SIBs because it will provide them with a larger buffer for loss-absorption and recapitalization in the event of bank failure.

The finalized regulation stipulates a minimum TLAC requirement of 16% of risk-weighted assets by 1 January 2025, rising to 18% by 2028, consistent with the Financial Stability Board's implementation recommendation for G-SIBs based in an emerging-market economy. China is the only emerging-market economy with G-SIBs.

A key focus of the regulation is the contractual subordination of noncapital TLAC liabilities. These future TLAC securities will include equity conversion or write-down features and have liability seniority contractually ranking between Tier 2 capital bonds and senior debts, similar to the senior non-preferred instruments issued in some European banking systems.

The regulation also stipulates that these noncapital TLAC liabilities' loss-absorption occurs after Tier 2 capital bonds. We estimate that the four G-SIBs would face a static gap of RMB3.7 trillion ($563 billion) in noncapital TLAC issuance were the TLAC requirements to take effect now, assuming a TLAC threshold of 18% of risk-weighted assets (see exhibit). The gap is likely to expand to RMB4.2 trillion by 2025 if the banks maintain their current pace of risk-weighted asset growth, return on equity and dividend payout ratios.

Chinese G-SIBs have a significant shortfall of total loss-absorbing capacity
Percent of risk-weighted assets unless otherwise indicated, as of 30 September 2021



Source: The banks

We expect the banks to issue their first noncapital TLAC securities in 2022 and to maintain a regular pace of issuance in 2023-24. We also expect them to replace some of their Tier 2 bonds, as well as senior unsecured debt issuance, with TLAC issuance, given that their total assets are unlikely to rise sharply in the next three years.

Compared with the draft regulation for public comments, the finalized TLAC regulation no longer requires the same nonviability trigger as that for Tier 2 capital bonds, indicating a greater willingness by regulators to support TLAC securities as opposed to Tier 2 bonds. Our working assumption is that elements of government support will flow through to noncapital TLAC securities. We expect Chinese regulators will act to avoid declaring a point of nonviability for the four Chinese G-SIBs because they are all majority government-owned, reducing the likelihood of equity conversion or write-downs of their future TLAC securities. However, the broad issue of banking system interconnectedness remains as TLAC securities are likely to be largely cross-held by banks and their wealth-management subsidiaries, as seen in additional Tier 1 securities and Tier 2 bonds so far.

Endnotes

1 Chinese G-SIBs are Industrial & Commercial Bank of China Ltd (A1 stable, baa1); China Construction Bank Corporation (A1 stable, baa1); Bank of China Limited (A1 stable, baa1) and Agricultural Bank of China Limited (A1 stable, baa2). The bank ratings in this report are the bank's deposit rating and Baseline Credit Assessment.

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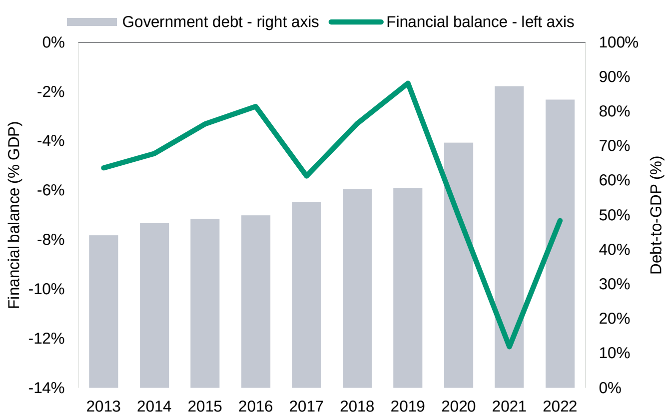
Bahamas' supplementary budget points to smaller-than-expected fiscal deficit on revenue outperformance

On 27 October, The Bahamas' (Ba3 negative) Prime Minister and Minister of Finance Philip Davis presented the supplementary budget for fiscal 2022 (ending 30 June 2022) to the House of Assembly, which showed better-than-expected revenue collection through the first quarter of fiscal 2022. The revenue outperformance will result in a fiscal deficit of $858.6 million in fiscal 2022, or 7.% of GDP, compared to the government's initial estimate of $951.8 million, a credit positive.

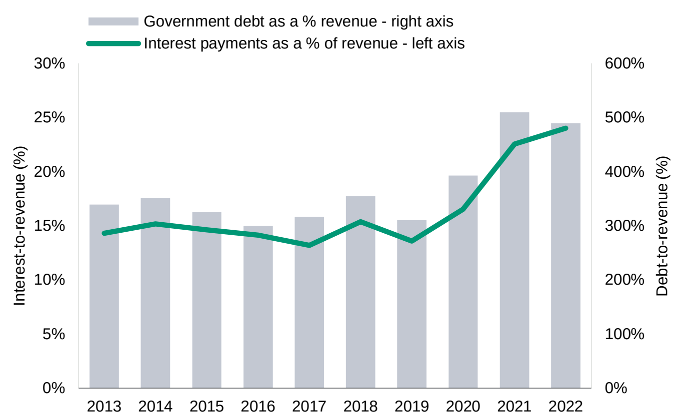
The supplementary budget highlights the link between tourism activity and tax collection in The Bahamas. The government's smaller projected budget deficit primarily reflects improved tax collection, which benefited from increased tourism activity as pandemic-related restrictions eased (see Exhibit 1). The Bahamas' relatively narrow revenue base was less than 19% of GDP in fiscal 2019 and is a key challenge in terms of debt affordability, which has deteriorated as the debt burden has risen (see Exhibit 2). The government aims to increase the revenue base to 25% of GDP by 2025. An increase of that size would be credit positive, but achieving it through improved tax compliance is unlikely. The government will present additional detail on how it intends to achieve the targeted revenue-to-GDP ratio in its mid-year budget.

Exhibit 1
The Bahamas' fiscal deficit widened sharply amid the pandemic, increasing government debt
% of GDP



Sources: Central Bank of The Bahamas and Moody's Investors Service

Exhibit 2
The Bahamas narrow revenue base constrain debt servicing capacity and weigh on debt affordability
% of government revenue



Sources: Central Bank of The Bahamas and Moody's Investors Service

The supplementary budget follows through on several campaign promises made ahead of the September 2021 general elections, in which the Progressive Liberal Party won the majority of seats in parliament. In particular, the government will reduce the value-added tax (VAT) to 10% from 12%, while eliminating several exempt items on the zero-rating list. The government expects the lower VAT rate's effect on revenue to be offset by eliminating the zero-rating items, which will broaden the VAT base while also improving tax compliance. The government will increase recurrent spending by more than $50 million in the current fiscal year, increase pension payments, public-sector salaries, extend the COVID-19 unemployment program until December and make a one-off $500 payment to individuals receiving support on the program. The spending will slow, but not derail, the pace of fiscal consolidation.

We continue to expect fiscal consolidation to be driven by a normalization of economic activity, which will support revenue collection and allow for the eventual removal of pandemic-related spending measures. Tourism activity has rebounded in recent months, driven by pent-up demand for travel in key source markets like the US (Aaa stable), while loosening pandemic-related travel restrictions in other source markets would likely support increased normalization in tourism activity.

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Dominican Republic's fiscal reform delay is credit negative, despite strong economic recovery

Originally [published](#) on 02 November 2021

On 27 October, Dominican Republic (Ba3 stable) President Luis Abinader announced that the government would indefinitely postpone a fiscal reform aimed at increasing government revenue. Abinader's announcement is credit negative because reforms that drive higher revenue would help the sovereign address its main credit weakness: low debt affordability. However, stronger economic growth, improved expenditure management and a lower debt burden in 2021 and 2022 will help mitigate the effect of the delayed reforms and partially reverse some coronavirus pandemic-related fiscal deterioration.

Despite a strong economic recovery and improving fiscal performance in 2021, the Dominican Republic's fiscal position is weak relative to rating peers, with interest/revenue more than double the median ratio of Ba-rated countries. Without taking material steps to implement durable reforms that improve government revenue collection, the sovereign's credit profile risks weakening in 2023 as economic growth and stronger budgetary outcomes likely moderates.

Dominican authorities were contemplating measures to broaden the tax base and eliminate tax exemptions to reverse some pandemic-fuelled fiscal deterioration, which includes the debt/GDP ratio increasing to 58% in 2020 from 42% in 2019 and interest/revenue rising to 23% from 19% over the same period. The government had originally planned to introduce the reforms in the first half of this year, but delayed them during the fourth-quarter budgetary process before postponing them indefinitely on 27 October.

The government's motivations for postponing the reforms reflect the economy's rapid recovery, which has improved fiscal accounts, along with high inflation from elevated fuel prices and global supply chain disruptions. These factors, along with a pending electricity tariff hike, contributed to the government's decision not to impose additional costs on the general public through higher taxes.

The economy grew by 12.7%, on an inflation-adjusted basis, during the first nine months of 2021 versus the same period in 2020, and we expect real GDP growth for the full year to exceed 10%. High growth has resulted in significant revenue buoyancy: central government revenue increased by 43% during the first half of 2021 and was 25% higher than the 2021 budget had projected. At the end of October, the government had a fiscal balance (0% of GDP) and will end the year with a budget deficit that is below the 4% of GDP outlined in the 2021 budget. Moreover, debt as share of GDP will decrease this year to less than 56% because of higher growth and significantly less borrowing.

In September 2021, the Dominican Republic's consumer price index was 7.7% higher than In September 2020. Rising prices in food and beverages (10%) and transportation (14%) have been the main drivers of inflation. The implementation of electricity sector reforms will raise the consumers' tariffs next year and mark the first rate increase since 2011. As a result, the authorities believe that introducing tax measures at this time would place an excessive burden on the population and hinder growth.

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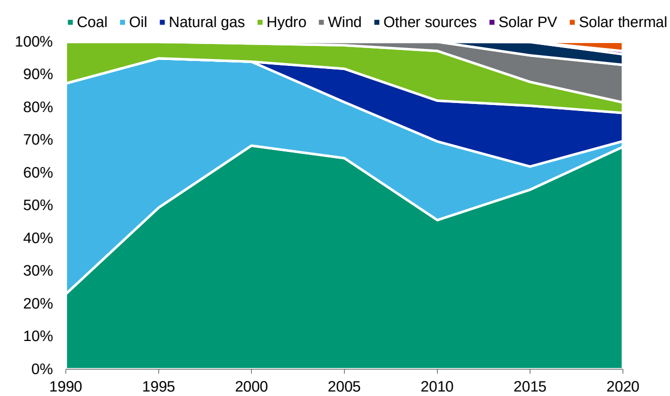
For Morocco, loss of Algerian gas supply is credit negative

Originally published on 02 November 2021

On 31 October, Algerian president Abdelmadjid Tebboune ordered the cessation of the country's gas exports to Spain through the Gaz-Maghreb-Europe (GME) line, which transits through Morocco (Ba1 negative), and to reroute them through the smaller Medgaz pipeline, which bypasses Morocco and connects directly to Spain. Algeria severed diplomatic ties with Morocco in August in response to growing bilateral tensions.

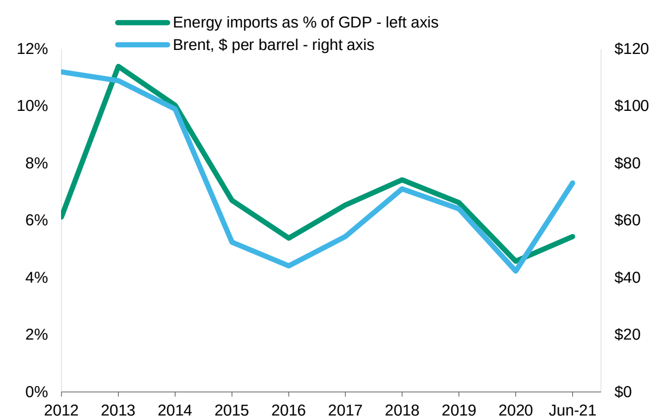
The GME transit suppression is credit negative for Morocco, which sourced up to 20% of its electricity production through natural gas imported almost exclusively from Algeria over the past five years (see Exhibit 1). Under the previous arrangement with Algeria, instead of paying transit fees, Morocco received natural gas from the pipeline, ensuring low cost gas supplies. The arrangement helped narrow the energy import bill over the past decade for Morocco, which remains heavily reliant on energy imports (see Exhibit 2). Higher post-pandemic energy prices will compound the interruption of access to Algerian gas and set the stage for a higher energy import bill, which underpins our current account deficit estimate at 3.4% of GDP this year and 3.6% in 2022 from 1.4% in 2020.

Exhibit 1
Natural gas contributed up to 20% of Morocco's electricity generation over the past five years
Electricity generation by source



Source: International Energy Agency

Exhibit 2
Morocco's reduced gas access and higher oil prices set the stage for a higher energy import bill



Sources: Haver Analytics and Moody's Investors Service

We do not expect immediate interruptions to electricity supply for consumers, but Morocco's limited immediate access to low-cost natural gas alternatives will likely increase the energy import bill in the near future and may lead to using more polluting fossil fuels like coal and fuel oil while the country's 2021-50 roadmap to replace coal with a lower-emission natural gas infrastructure takes effect. In the meantime, the government continues to pursue its objective to expand the share of renewable energy sources in electricity production to 52% by 2030 from 22% in 2020 and 5% in 1995, according to IEA data. While this is an ambitious target, Morocco remains one of the most advanced countries in the Middle East North Africa region for renewable energy project implementation.

Morocco's immediate options to source natural gas elsewhere are limited. The liquefied natural gas (LNG) infrastructure, which is a key pillar under the government's new natural gas development roadmap, is still in the development stage. While the original Gas-to-Power strategy included a fixed LNG terminal, the government is now considering a more flexible strategy involving a Floating Storage Regasification Unit (FSRU) import infrastructure. Bids to build and operate a FSRU were submitted earlier this year and the bidding process was extended on 15 October. The government is also evaluating the option of reversing the gas flow of the GME pipeline to import gas from Spain, taking advantage of that country's existing LNG infrastructure.

A longer-term project that remains a distant prospect in our view is the Morocco-Nigeria Gas Pipeline, which would extend the existing West African Gas Pipeline running from Nigeria and connecting Benin, Togo and Ghana to include all 13 countries along the West African coast. It would replace the previously considered Trans-Saharan pipeline project because of the significant risk of militant attacks. Even in a best-case scenario, that project has a 25-year timeline and has significant implementation challenges.

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Malaysia's 2022 budget increases fiscal challenges, focusing on recovery and revenue reform

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On 29 October, Malaysia (A3 stable) published its 2022 budget, which totaled MYR332 billion ($80 billion or 20% of our forecasted 2022 nominal GDP) and was modestly higher than the total 2021 budget. The budget entails a continued accommodative stance that will result in a more gradual fiscal consolidation path, and aims to broaden the economic recovery, strengthen private-sector resilience and further develop its digitalisation and sustainability agenda. However, the budget suggests wider for longer fiscal deficits over the next two to four years, implying a backloading of efforts to reduce Malaysia's already-high debt burden, a credit negative.

We currently expect Malaysia's 2022 fiscal deficit to consolidate to 5.5%-6.0% of GDP, versus 6.5%-7.0% for 2021. Our expectation of a gradual narrowing of the fiscal deficit takes into consideration our assumption for further economic normalisation and increased petroleum-related revenue from higher oil prices, which we forecast will be $50-$70 per barrel over the next three to five years.

Malaysia's deficit will be almost entirely funded through domestic financing without needing to access its reserves, underscoring Malaysia's highly rated government liquidity risk and access to a deep domestic investor base. We expect deficits to remain wider than the pre-pandemic average of 3%-4% over the next two to four years. Projections in the budget's Medium-Term Fiscal Framework indicate that the government expects fiscal deficits to average 5.0% of GDP over 2022-24, up from the 2021 budget's estimate of an average of 4.5% over 2021-23.

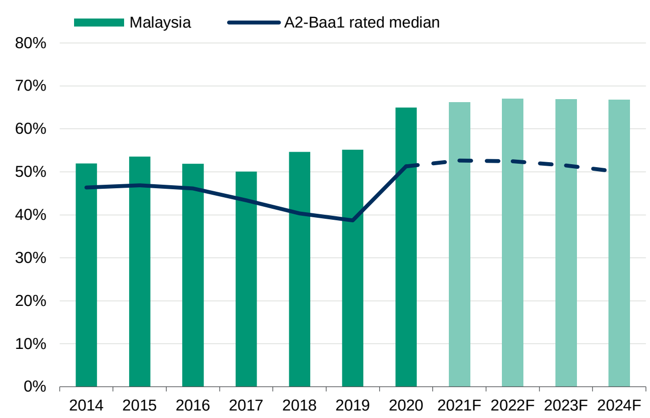
Wider deficits suggest that Malaysia's debt burden will remain higher for longer. In anticipation of higher debt levels, the government has sought parliamentary approval to temporarily raise its statutory debt limit[1] to 65% of GDP from 60% until the end of 2022, by which time the government aims to reduce the debt burden back to below 60%. Nevertheless, we expect Malaysia's debt burden to remain elevated above pre-pandemic levels over the next four years.

We currently forecast the debt burden[2] to peak at around 67% of GDP in 2022, and remain above 65% through at least 2025, exceeding the A2- Baa1-rated median of about 53% (see Exhibit 1). Additionally, we expect that debt affordability – as measured by the ratio of interest payments to revenue – will continue to be a credit constraint and remain weak at 12%-13% of revenue in 2022-24 (see Exhibit 2), owing to a narrow government revenue base and a modest recovery next year. However, new tax measures have the potential to increase revenue beyond the government's current expectations.

Exhibit 1

Malaysia's debt burden will remain higher than the median of its peers...

General government debt, % of GDP

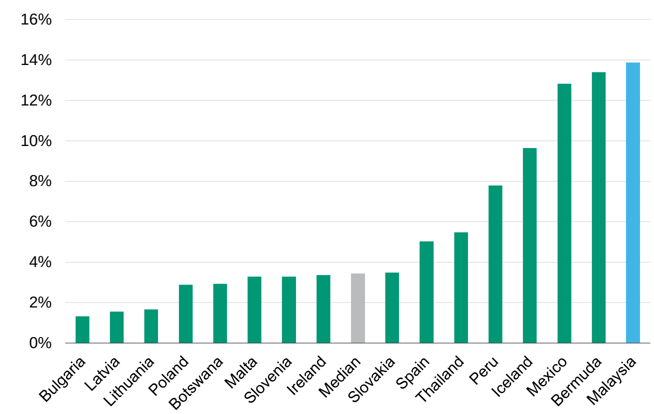


Source: Moody's Investors Service

Exhibit 2

...while debt affordability will remain a key credit constraint

Interest payments as a % of revenue, 2021 forecast



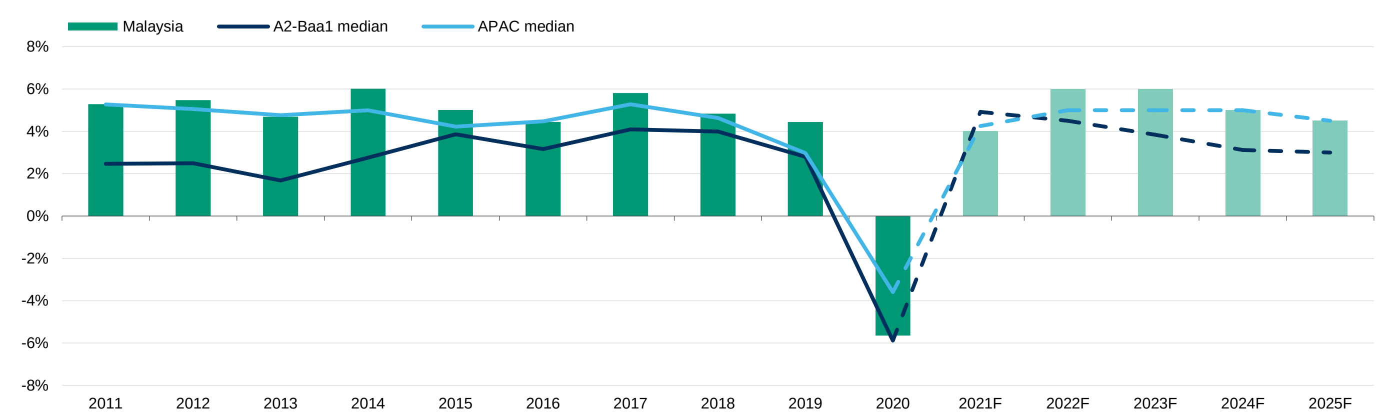
A2-Baa1 rated sovereigns and median.
Source: Moody's Investors Service

Although Malaysia's expansionary budget points an increase in fiscal challenges in 2022, we expect the increased spending to support economic recovery. Also supporting the recovery is Malaysia's relatively high vaccination rate, with more than 75% of the population fully inoculated as of 1 November, which allowed an easing of domestic and international borders in October. As a result, we expect Malaysia's real GDP to rebound to 6%-7% in 2022 from 4% in 2021, before normalising to 4.5%-5.5% in 2023-25 (see Exhibit 3).

Exhibit 3

Malaysia's expansionary budget, along with easing of restrictions, will spur economic growth

Real GDP growth



Source: Moody's Investors Service

The overarching objectives highlighted in the budget are enhancing social protection, reviving and strengthening businesses and driving strategic investments. Socioeconomic measures include cash handouts to a larger share of vulnerable households, greater access to health care and education and job creation. For businesses, microcredit schemes, financing guarantees and tax deductions will help ease liquidity challenges, plus there are targeted measures for the tourism, creative and retail industries such as wage subsidies.

Strategic investments highlighted in the budget will strengthen Malaysia's long-term competitiveness. These include a MYR2 billion fund to attract direct investments by multinationals, further develop the country's digitalisation strategy and continue infrastructure projects such as the Pan Borneo Highway.

Endnotes

1 Malaysia's statutory debt limit covers both long-term conventional and Islamic notes as well as short-term Islamic bills, but not conventional Treasury bills.

2 Our estimates for Malaysia's government debt considers the debt of state-owned enterprises 1Malaysia Development Berhad (1MDB), SRC International and Suria Strategic Energy Resources, which benefit from an explicit guarantee from the federal government and, in our view, are unlikely to be able to service their debt independently.

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Global credit environment will stabilize in 2022 as COVID-19 uncertainties ebb

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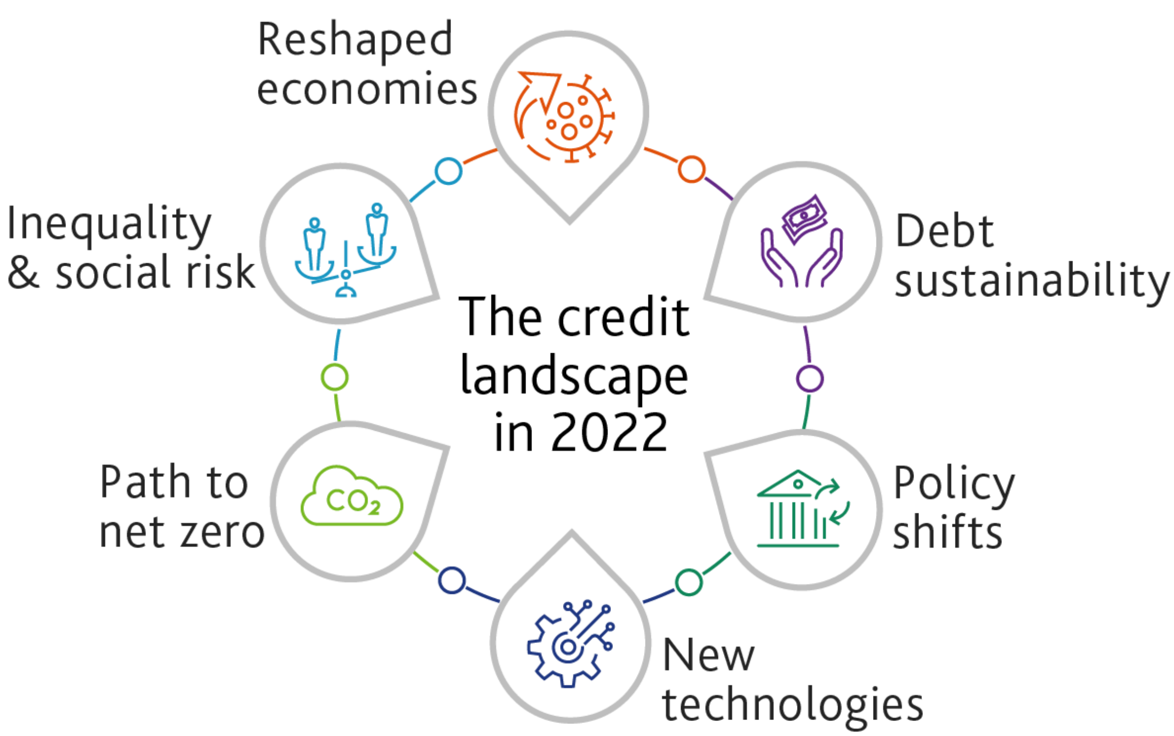
Global credit conditions are poised to stabilize in 2022, although with stark differences across regions and economic sectors. Steadying economic activity, supported by progress in vaccinations against COVID-19, will drive enhanced credit quality of debt issuers overall. Yet leverage risks will remain high, creating repayment risks where economic growth, corporate earnings and government revenue prospects weaken, or liquidity wanes. COVID-19 will remain a public health threat, particularly in countries where vaccination rates remain low. However, many of the uncertainties related to the pandemic will begin to subside absent a widespread global surge in cases tied to the emergence of vaccine-resistant virus strains.

Six major themes will drive credit dynamics in 2022: **reshaped economies**, as COVID-19's aftershocks continue to reverberate; **debt sustainability,** as governments and companies grapple with managing increased debt loads; **policy shifts,** as fiscal and monetary support is gradually pared back in many countries; **new technologies** as they transform ways of producing, financing, consuming and working; the**path to net-zero** emissions and what carbon transition means for energy-intensive sectors and their access to capital; and increasing focus on **inequality and social risk**, which can pose threats to societal cohesion and economic progress.

Economic recovery, policy, tech and ESG factors will drive the credit environment



Source: Moody's Investors Service

Reshaped economies

COVID-19's aftershocks will continue to reshape economies. The COVID-19 pandemic has had devastating effects on human health, resulting in nearly 5 million deaths globally so far. It has also reshaped the global economic environment, and its aftershocks will continue to reverberate in 2022. Overall, we expect the global economic recovery to further solidify throughout the year, led by slowing but still solid growth in the US (Aaa stable) and China (A1 stable). But economic prospects will vary worldwide – starkly, in some cases – by region and sector.

The course of the pandemic poses the most immediate risk to the recovery, but its importance in determining the economy's trajectory will lessen as 2022 progresses. We expect the public health situation to improve as vaccinations against COVID-19 increase and societies continue to adapt to new protocols. But the virus will remain endemic, and there also remains a downside scenario in which vaccine-resistant variants emerge that prolong the crisis and require new containment measures. Further risks to the recovery stem from longer-than-expected supply chain disruptions, longer-lasting labor shortages and higher-than-expected inflation.

In many economies with high vaccination rates, improvement in the public health situation will allow for a greater resumption of business activity and a firming of the economic recovery. As Exhibit 2 shows, most of the G-20 economies will have surpassed the pre-pandemic level of real GDP by the end of this year. The rest, including Italy (Baa3 stable), Argentina (Ca stable) and South Africa (Ba2 negative), will return to pre-pandemic levels by the end of 2022, according to our forecasts.

Progress will be slower in many low-income countries that have struggled to gain access to vaccines or distribute them. The pandemic's economic damage is reversing gains that many of these countries had made in reducing poverty, alleviating food insecurity and improving educational opportunities for the most vulnerable. The challenges will be particularly profound for low-rated countries whose fiscal deficits have risen during the crisis and that have limited access to financing. The shock also has had especially negative effects on some countries with limited economic diversification, such as those heavily dependent on oil exports, commodities or tourism. Those with a large reliance on tourism will encounter particular challenges given that the sector likely will not fully recover for another two years.

The steadying economic outlook bodes well for an earnings revival for financially stronger companies, with large differences, however, by region, sector and size. There are signs that aggregate corporate credit quality is improving, with upgrades of speculative-grade companies outpacing downgrades over the 12 months ended in September 2021. Nevertheless, many lower-rated companies remain fragile, with balance sheets and cash flow that have yet to recover from the pandemic's economic toll. In particular, the credit environment will become less benign for companies in many emerging market countries as funding conditions gradually turn less supportive.

In our base case, supply chain disruptions, labor shortages and higher prices for some goods and services resulting from pandemic-induced lockdowns and fitful reopenings will stretch into 2022, but their effects will lessen in the second half of the year. In most economies, we expect inflation to subside in 2022 from elevated 2021 levels as base effects reverse and the effects of one-off price increases fade. But there is considerable uncertainty around our forecasts and a risk that inflation will remain higher for longer than expected, particularly in the US and in some emerging market countries. Elevated inflation will strain household budgets and weigh on growth, especially if job market conditions remain weak. It also has the potential to trigger food price controls and mandated wage hikes in emerging markets, which could weaken corporate profitability in affected sectors in those countries.

Debt sustainability

High debt burden will pose repayment risks if growth stalls and liquidity recedes. The COVID-19 pandemic has left a legacy of high government and corporate indebtedness, which will create repayment risks where growth and earnings prospects weaken or liquidity wanes. Sovereign debt loads already had been climbing since the global financial crisis, but fiscal spending in response to COVID-19 has pushed borrowing higher, as Exhibit 5 shows. Advanced economies have much more room to maneuver than do emerging and frontier economies, as many of them have experienced declining debt servicing costs over the last decade. Among corporate borrowers, debt burdens will start to stabilize as a result of improved revenue and earnings, but the outlook varies by sector and company size. Low-rated companies that remain under liquidity or solvency stress may encounter increased challenges.

Policy shifts

Policy environment will reflect cautious phaseout of COVID-19 fiscal and monetary support. Further economic recovery will allow many countries to dial back COVID-19 support measures in 2022. Improvement in government revenue will lead to a slight reduction in fiscal deficits, but societal calls for stronger social safety nets and measures to address longer-term challenges such as climate change will lead to continued demands on government spending.

We expect monetary policy globally to shift gradually from accommodative to neutral over the next two years, and monetary and financial conditions to tighten somewhat. Most central banks in advanced economies will reduce policy accommodation only gradually and as their economies recover, which will support funding conditions and mitigate the negative credit impact for debt issuers.

New technologies

New technologies will accelerate shifts in corporate operating environments. Technological innovation in the areas of artificial intelligence, blockchain, data analytics, robotics and renewable energy will continue to disrupt financial services, autos, agriculture and other sectors, creating opportunities for new market entrants and posing risks for industry incumbents that are slow to adapt. In healthcare, the rapid development of COVID-19 vaccines based on messenger RNA technology may help speed up innovation in other areas of healthcare. Companies that cannot keep up with technological change will risk losing revenue and market share, jeopardizing their competitive position and credit standing.

The financial and wealth management industries are poised to undergo particularly weighty shifts as a result of applications from new technologies, with Big Tech companies likely to use their capabilities in accumulating, analyzing and modeling data to make further inroads in banking and other financial services. Data gathered by e-commerce companies such as Alibaba (A1 stable) in China, MercadoLibre (Ba1 stable) in Latin America and Amazon (A1 stable) in the US and beyond set them in a strong position to assess financial risk and return.

Path to net zero

Meeting net-zero emissions targets will require massive shifts in policy and investment. The tightening of policy and financial sector commitments to reach net-zero carbon emissions – the process of reducing emissions so that the amount going into the atmosphere is balanced by the amount being removed from it – will continue to raise the pressure for decarbonization across industries and to affect the cost of capital. As the frequency of extreme climate events picks up, carbon transition is becoming an increasingly important credit consideration. Some companies are already undergoing rapid changes in anticipation of the need to become less carbon dependent, while market participants are pressing others to articulate how they will do so. Those seen as noncompliant will likely incur more limited access to capital or pay a premium for financing.

Ahead of the November 2021 UN Climate Change Conference (COP) in Glasgow, many countries set out plans to reduce their emissions; other countries are considering policy steps. As Exhibit 10 shows, major commitments announced in 2021 include the

US target of reducing greenhouse gas emissions by 50%-52% in 2030 from 2005 levels, the EU's target of cutting greenhouse gas emissions by at least 55% by 2030 from 1990 levels and China's announcement that it targets peak use of coal by mid-decade followed by a phased reduction through 2030 and then carbon neutrality by 2060.

Inequality & social risk

Inequality and social risk will come into greater focus. The COVID-19 crisis has illuminated persistent income, racial and gender inequalities globally, and focused attention on the vast differences in labor conditions, healthcare access and opportunities within and between countries. These factors will likely have ramifications for government policy and spending. In certain countries, social tensions that lead to widespread unrest will have potential to erode governments' legitimacy and weaken their institutional strength.

Social challenges exacerbated by the pandemic will likely stretch on for years, affecting emerging and advanced economies alike. In a number of upper-middle and high-income countries, particularly in Latin America, the pandemic has worsened inequalities given the disproportionate impact on employment. In Chile, for example, social demands for better quality and coverage of public services are rising, which in the absence of additional revenue measures would create risks of a further increase in the country's national debt burden. Colombia made progress in reducing poverty over the past two decades, but persistently high levels of rural-urban income inequality are a risk factor that could lead to social unrest.

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