# Credit Outlook

11 November 2021

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## FIRST READS

# US infrastructure bill will support economic expansion and benefit a range of sectors

*Originally published on 08 November 2021*

On 5 November, the US (Aaa stable) House of Representatives passed the Infrastructure Investment and Jobs Act. The Senate passed the same version of the bill on 10 August, and we expect President Joseph Biden to sign the legislation into law in the coming days. The $1 trillion spending package reauthorizes a range of existing federal infrastructure funding programs and increases federal investment in physical and digital infrastructure by about $550 billion (2.8% of 2021 GDP) over five years, a credit positive for state and local governments, electric utilities and power companies, and for a range of companies in construction-related sectors (see Exhibit 1).

Exhibit 1
**The Infrastructure Investment and Jobs Act is credit positive for a range of sectors**

**State and local governments:** federal spending will provide economic, fiscal and social benefits

**Utilities and power companies:** funding will support grid resiliency and facilitate the integration of renewable energy resources

**Cable companies:** funding for broadband expansion presents opportunities

**Infrastructure issuers:** funding for transportation will reduce need for debt-financed investments

**Construction, engineering, building material companies:** increased demand, higher prices, will boost profitability

**Chemical producers:** Superfund fee will largely be offset by higher demand for certain chemicals

*Source: Moody's Investors Service*

On its own, the increased federal spending on infrastructure likely will unlock additional private and public-sector investment. When taken together with the roughly $2 trillion in additional investments in clean energy, healthcare, education and housing included in the House version of the Biden administration's proposed Build Back Better Act, the boost to growth and productivity could be significant. If the Democrat-controlled House passes that bill, we expect the Senate to pass a slimmer version that is closer to the $1.75 trillion framework that the White House proposed. This would bring the total spending for both bills to about $2.2 trillion.

The Infrastructure Investment and Jobs Act will have limited effects on the **sovereign**'s fiscal dynamics. The plan's largest revenue offsets include redirecting unused COVID-19 relief funds. We expect the federal government's fiscal deficit to narrow significantly in 2022 to just over 5% of GDP, from around 12.5% in 2021, driven by a substantial decline in emergency COVID-19 relief spending. The Congressional Budget Office estimates that the infrastructure legislation will cause deficits to rise by $256 billion over the next 10 years (equivalent to about 0.13% of 2021 GDP per year).

The legislation increases federal funding for highways, roads, bridges, transit and water systems, a credit positive for **state and local governments**, which undertake the bulk of public-sector investment in the US. The funding will allow them to maintain rapidly aging assets and clear project backlogs, supporting economic activity and revenue growth. Together with a strong revenue environment and low borrowing costs, the additional federal funds will likely result in a rebound in capital spending by municipal issuers over the next several years.

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Although states will largely decide which projects to prioritize, the legislation includes significant funding for existing competitive grant programs. It also creates new dedicated grant programs, such as a program to replace and repair bridges. Localities will likely need to show that their projects meet certain eligibility criteria to receive funding through these programs. We expect the federal government to provide details of how the new programs will work over the coming months.

Gains for state and local governments will go beyond funding for core infrastructure. For example, investments in broadband will provide economic and social benefits to rural and underserved urban communities. Investments in power sector resiliency will mitigate the negative impact of extreme weather on local economies. The legislation also makes $1 billion available for state, local, tribal and territorial governments to ward off cyberattacks, which will help reduce the impact of financial harm and interruption of essential service related to such attacks.

The new funding for **airports, ports, transit and roads** will allow them to maintain or upgrade assets without incurring additional debt. However, the amounts allocated generally fall short of what industry trade groups estimate are required to meet infrastructure needs. Nevertheless, the law is particularly credit positive for Amtrak (A1 stable). The $66 billion investment in Amtrak, relative to the rail company's $1.4 billion in adjusted debt as of September 30, 2020, would free up substantial additional funding for a renewal of its fleet, the replacement and rehabilitation of Northeast Corridor infrastructure, and the development of new routes or expansion of service on underserved routes. At the same time, this investment comes with high execution risk and the risk of investing in new routes with a limited return on investment or limited ridership that require long-term maintenance.

The infrastructure package also includes measures that are favorable for **public-private partnerships (PPPs)** and will likely result in an increase in PPPs. For example, it requires any transportation project receiving federal assistance and costing more than $750 million to assess if a PPP provides more long-term value than a traditional design-bid-build approach. The inclusion of $100 million for PPP capacity-building will help new governmental entities explore the PPP procurement model for capital projects. The legislation also raises the cap on private activity bonds to $30 billion from $15 billion, allowing private entities to benefit from tax-exempt bond treatment to finance certain public works improvements like highways.

The additional spending on infrastructure will spur an increase in construction activity that will support long-term, sustainable price increases for **building materials**. The industry is operating at full capacity, its products have few if any substitutes, and there is limited expansion capacity because of restrictive environmental laws. Higher prices and demand will lead to higher profitability and free cash generation for rated issuers in the sector, including European companies with a large footprint in the US. **Construction companies, engineering firms** and companies that serve the utilities, renewables, telecom and dredging sectors will also benefit from the increase in construction activity. However, the magnitude of the impact on revenue and profitability will depend on the amount of work they win and the margins they generate on that work, and on the effects of pricing pressures on inputs and labor.

The primary credit benefit for **electric utilities and power companies** will come from $65 billion of funding for enhancing grid resiliency, facilitating the integration of renewable energy resources and supporting energy-related technologies. One of the most supportive provisions is a $5 billion Department of Energy grant program to provide funds to improve grid reliability in the face of extreme weather, wildfires and other natural disasters, an important benefit for the sector given the higher frequency and severity of storms, droughts, wildfires and similar events.

The legislation includes $7.5 billion in funding for charging stations. This investment is credit positive for the utilities and power sector to the extent that it accelerates the adoption of electric vehicles, increases electricity demand and offsets long-term declines in demand caused by energy efficiency and demand-side management programs. Additionally, funding to support the development of a variety of new energy-related technologies could ease the transition of the utility and power sector to a carbon-neutral – and, eventually, a carbon-free – future. These technologies include hydrogen, battery storage and carbon capture, which are in relatively early stages of development.

The $65 billion in funding for broadband expansion via grants to states is credit positive for **cable operators** that states select to deliver broadband services to new customers. The legislation also includes the extension of subsidies in the form of monthly vouchers for internet services to low-income households put in place during the pandemic.

The legislation reinstates excise taxes on the production of certain chemicals to fund environmental cleanup at Superfund sites, a tax that had expired in 1995. The tax will have limited financial impact on **chemical producers** and will largely be offset by higher demand for certain chemicals driven by the spending package's investments in transportation, water, power and broadband.

Exhibit 2

**Summary of key provisions and pay-fors in the Infrastructure Investment and Jobs Act**

| Spending provisions | $ billions |
|---|---|
| **Transportation** | **$269** |
| *Roads and bridges* | $110 |
| *Passenger and freight rail* | $66 |
| *Public transit* | $39 |
| *Airports* | $25 |
| *Ports and waterways* | $17 |
| *Road safety* | $11 |
| *Reconnecting communities* | $1 |
| **Power infrastructure** | **$65** |
| **Broadband** | **$65** |
| **Water infrastructure** | **$55** |
| **Electrification** | **$15** |
| **System resiliency** | **$47** |
| **Environmental remediation** | **$21** |
| **Western water infrastructure** | **$8** |
| **Total** | **$545** |

| Offsets | $ billions |
|---|---|
| **Repurpose COVID funds** | **$43** |
| **Delay Medicare Part D rebate rule** | **$51** |
| **Sell spectrum and apply proceeds from previous sales** | **$10** |
| **Require information reporting for cryptocurrency transactions** | **$28** |
| **Extend fees on Government-Sponsored Enterprises** | **$21** |
| **Reinstate Superfund fees** | **$14** |
| **Extend mandatory sequester** | **$21** |
| **Other** | **$18** |
| **Total** | **$206** |

Based on Senate summary released on 3 August 2021.

*Sources: US Congress and Congressional Budget Office and Committee for a Responsible Federal Budget*

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# US infrastructure legislation offers years of visibility to building materials sector

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On 5 November, the US House of Representatives passed the Infrastructure Investment and Jobs Act. The $1.0 trillion, multiyear infrastructure bill, increases the US government (Aaa stable) investments in physical and digital infrastructure by about $550 billion (~2.8% of 2021 GDP) over five years and sets the stage for further strong growth in volume and earnings for companies that produce aggregates, concrete and cement.

**Infrastructure funding plan will boost US construction activities for years**. In addition to aging roads, bridges and other infrastructure across the US badly in need of repair and years of underbuilt conditions, we believe factors that will support continued robust construction activity include population growth, more miles driven, as well as low interest rates.

For 2022 and 2023, we project US construction spending to grow about 5% (see Exhibit 1). Persistent labor shortages could affect our growth assumptions. For 2023, we project the infrastructure bill to significantly boost US construction spending in education, transportation, power, and highway and street work, offsetting slower activity in private residential construction.

Exhibit 1
**Infrastructure bill to add around $35 billion to US construction activity in 2023**

| | Construction spending at 07/31/21 in $mm | Segment Breakdown | 2018 YoY % change | 2019 YoY % change | 2020 YoY % change | 2021 YTD Jan-July | 2021P YoY % change | 2022P YoY % change | 2023P YoY % change | 2022P YoY % change w/ Bill | 2023P YoY % change w/ Bill |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Total Construction Spending | 1,568,834 | 100.0% | 4.1% | 2.3% | 5.6% | 6.8% | 7.0% | 6.0% | 3.8% | 6.5% | 5.5% |
| Total Residential | 782,127 | 49.9% | xx | -2.5% | 15.3% | 22.6% | 20.0% | 7.5% | 4.0% | 7.5% | 4.0% |
| Total Non Residential | 786,706 | 50.1% | xx | 5.8% | -0.8% | -5.3% | -3.0% | 4.5% | 3.7% | 5.5% | 6.9% |
| Total Public Spending | 337,833 | 21.5% | xx | 8.0% | 4.9% | -6.5% | -5.6% | 6.3% | 3.5% | 8.3% | 6.8% |
| Public Residential | 9,165 | 0.6% | xx | 2.1% | 41.6% | -0.3% | 1.0% | 5.0% | 5.0% | 6.0% | 8.0% |
| Public Non Residential | 328,669 | 22.1% | xx | 8.1% | 7.3% | -6.6% | -5.8% | 6.3% | 3.7% | 6.0% | 8.0% |
| Office | 11,301 | 0.7% | xx | 10.9% | 10.8% | -6.6% | -5.0% | 3.0% | -3.0% | 5.0% | 0.0% |
| Commercial | 3,421 | 0.2% | xx | 11.8% | 2.2% | -16.4% | -15.0% | 4.0% | 1.0% | 6.0% | 4.0% |
| Healthcare | 10,048 | 0.6% | xx | 0.0% | 6.0% | 2.2% | 3.0% | 6.0% | 5.0% | 8.0% | 8.0% |
| Education | 79,697 | 5.1% | xx | 0.0% | 5.7% | -10.5% | -9.0% | 10.0% | 3.5% | 12.0% | 6.5% |
| Public Safety | 11,590 | 0.7% | xx | 12.0% | 72.1% | -34.6% | -30.0% | 5.0% | -5.0% | 7.0% | -2.0% |
| Amusement & Recreation | 13,393 | 0.9% | xx | 10.7% | 3.7% | -5.5% | -5.0% | 3.0% | -1.0% | 5.0% | 2.0% |
| Transportation | 41,323 | 2.6% | xx | 13.4% | 9.3% | -5.6% | -5.0% | 10.0% | 5.0% | 12.0% | 8.0% |
| Power | 8,421 | 0.5% | xx | 29.3% | 6.4% | 17.4% | 20.0% | 9.0% | 2.0% | 11.0% | 5.0% |
| Highway & Street | 94,472 | 6.0% | xx | 7.2% | 2.5% | -5.1% | -4.0% | 3.5% | 5.0% | 5.5% | 8.0% |
| Sewage & Waste Disposal | 27,512 | 1.8% | xx | 7.1% | 2.2% | 5.9% | 5.0% | 3.5% | 3.5% | 5.5% | 6.5% |
| Water Supply | 18,436 | 1.2% | xx | 2.3% | 16.9% | 1.6% | 2.0% | 7.5% | 10.0% | 9.5% | 13.0% |
| Conservation & Development | 7,808 | 0.5% | xx | 10.6% | -1.9% | -12.1% | -8.0% | 2.0% | 3.0% | 4.0% | 6.0% |

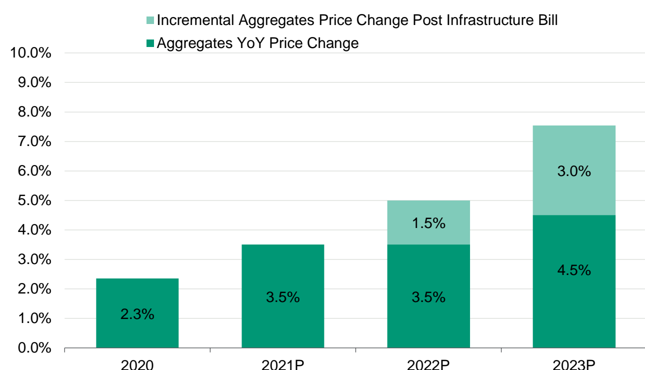
*Sources: US Census Bureau and Moody's Investors Service*

**Building materials will benefit substantially**. Half of aggregates demand in the US typically goes to public infrastructure (highway, roads, and rail roads), with the rest equally split between residential and nonresidential construction. Demand for cement is mostly driven by residential and noncommercial facilities (such as building, bridges, ports, airports, data centers, wind mills).

**Aggregates, cement and concrete ready-mix producers will see material increases in volume demand and prices**. In 2023, we expect the infrastructure bill will boost volume by an incremental 3% for building materials. We also project pricing for aggregates will rise an incremental 3%, and 4% (at least) for cement and ready-mix concrete producers that are operating at full capacity (see Exhibits 2-5). US cement producers are already operating at full capacity, limiting any ability to increase supply and offering the cement

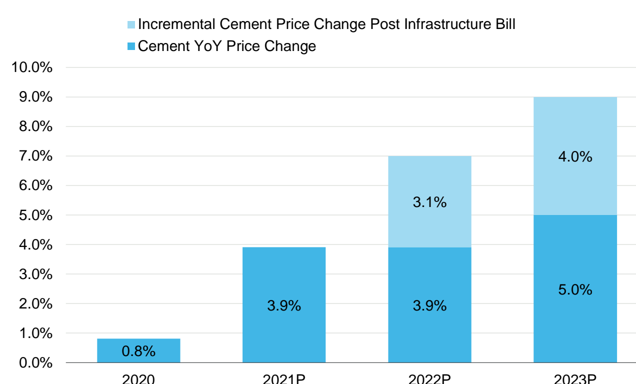
manufacturers sustainable pricing power. In recent years, industry consolidation and environmental regulations limited expansion or new entrants, forcing reliance on imports — which account for 15% of total consumption in the US. Importing cement is not ideal, however, because transport costs can quickly outstrip profit if customers are more than 100 miles from a port.

Exhibit 2
**Aggregates year-over-year price change**



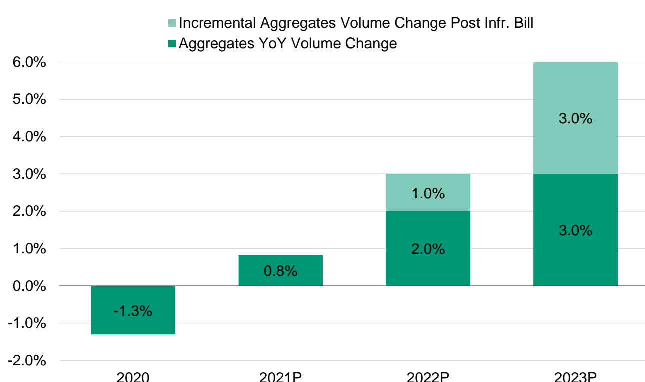

*Source: Moody's Investors Service*

Exhibit 3
**Cement year-over-year price change**



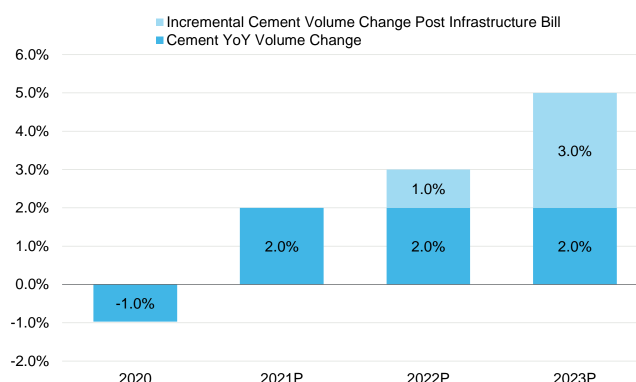

*Source: Moody's Investors Service*

Exhibit 4
**Aggregates year-over-year volume change**




*Source: Moody's Investors Service*

Exhibit 5
**Cement year-over-year volume change**




*Source: Moody's Investors Service*

**EBITDA and free cash flow growth are likely throughout the industry**. We expect EBITDA and free cash flow growth at 7% - 9% in 2022 and 11% - 13% in 2023. The increase in EBITDA and free cash flow is driven by higher volume and pricing. We expect the infrastructure bill to provide long-term, sustainable price increases for building materials, which have no substitutes and enjoy high barriers to entry.

**Debt capacity to increase**. The multiyear infrastructure spending plan provides long-term stable demand and free cash flow predictability, a distinct change for the sector that has long been highly cyclical with limited demand visibility beyond 12 months. This will enable building material companies to take on more debt without significantly increasing their financial risk. How companies in the sector leverage this increased debt capacity will be driven by their financial policies and strategic plans. We believe the larger debt capacity will be primarily used for opportunistic mergers and acquisitions, rather than increased cash distributions to shareholders.

**M&A activity likely to continue**. We expect continued M&A activity among aggregates and concrete ready-mix providers, less in the cement industry which is already fully consolidated. The Top 5 cement producers already control 75% of domestic production, with the Top 8 representing more than 90% of the market. Meanwhile, the aggregates industry remains fairly fragmented and we expect the larger aggregate companies to pursue additional tuck-in acquisitions, while maintaining a conservative approach to balance sheet

management and liquidity. Among concrete ready-mix suppliers, we also expect further consolidation to increase the density of their footprints, which will improve operating efficiency.

**Rated domestic companies will benefit.** Eagle Materials Inc. (Baa2 stable), Martin Marietta Materials Inc. (Baa2 stable), Vulcan Materials Company (Baa2 stable), Summit Materials LLC (Ba3 stable), Forterra Finance LLC (B1 stable), Smyrna Ready Mix Concrete LLC (B1 stable), and New Enterprise Stone & Lime Co. Inc. (B3 stable) all generate significant portions of their revenue from US construction work or construction materials.

**EMEA-based companies with strong presence in the USwill also benefit**. European building materials firms including CRH plc (Baa1 stable), HeidelbergCement AG (Baa2 stable), Holcim Ltd. (Baa2 positive), and LSF11 Skyscraper HoldCo S.a.r.l. (B2 stable), a producer of concrete admixture and construction systems, are also poised to benefit.

**Companies within the basic industries could also benefit**. This includes engineering & construction companies and those that serve the utilities, renewables, telecom and dredging sectors. However, the magnitude of the benefit for each will be dictated by the amount of work they win through competitive bidding and the margins they generate on that work, which could be affected by cost inflation.

Tutor Perini Corporation (B2 stable) and MasTec Inc. (Ba1 stable) are both involved in domestic infrastructure construction, as are, to a lesser degree, Fluor Corporation (Ba1 negative) and AECOM (Ba2 stable). Others companies that provide services to utilities, like Quanta Services (Baa3 stable), Pike Corporation (B2 stable), and Artera Services, LLC (B3 stable), or those like Dycom Industries Inc. (Ba2 stable), and QualTek LLC (B3 negative), that service telecom operators, will all eventually receive some economic benefits — but not until 2023 or even 2024. Companies with exposure to renewable energy construction, like IEA Energy Services LLC (B2 stable) and Centuri Group Inc. (Ba2 stable), could also benefit at a later stage.

**Providers of chemicals for building materials will also see material improvements in demand.** We expect companies like GCP Applied Technologies (Ba3 stable), a producer of cement additives, concrete admixtures and specialty building materials, and Koppers Holdings Inc. (Ba3 stable), a global producer of wood treatment chemicals servicing the utility, telecom, railroad, residential lumber, steel and aluminum industries, to benefit from increased infrastructure spending. The magnitude and the timing of the benefits are as yet unclear.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# GE's spin-off of Healthcare segment is credit negative, but an improving Aviation unit will help fill the gap

On 9 November, General Electric Company (Baa1 negative) announced that it plans to separate into independent companies, with the company expecting a spin-off of its Healthcare segment to be completed in early 2023. The deal is credit negative because GE will be losing the healthcare business, which is high margin with strong cash conversion.

However, we do not expect the plan to hurt GE’s efforts to deleverage over the next two years. Additionally, GE's Aviation segment will have sufficiently strengthened by the time of the Healthcare separation that it can substitute Healthcare as the primary pillar of GE's credit profile. Following the announcement, we affirmed GE's rating and outlook.

GE's credit quality balances the continuing challenges that the company faces in its Aviation, Power and Renewable Energy segments, and the prospects for improved earnings and cash flows over time as the company restructures its businesses, implements lean processes and realizes the benefits from its vast installed base and order backlogs. Aided by technological leadership, GE maintains a clear competitive presence in critical industries. The company's credit quality also consider the progress that GE has made to date in managing its operations, improving its financial performance, deleveraging its balance sheet and addressing its contingent liabilities.

We continue to expect that even after the separation of Healthcare, GE will improve the earnings and cash flow from its remaining industrial operations such that its credit metrics become aligned with our quantitative expectations for the Baa1 senior unsecured debt rating by 2023. We anticipate that GE's previously announced reduction in debt and other obligations of about $60 billion between 2021 and 2023 will be augmented by the de facto transfer of a substantial amount of debt and other obligations to Healthcare at the time of the spin-off. In addition, GE will retain an ownership interest in Healthcare of 19.9% that it could divest to help fund additional debt reductions.

GE's liquidity is good: the company had a total cash balance of $25 billion at the end of September, boosted further by the $23 billion upfront cash proceeds from the combination of GE Capital Aviation Services with AerCap Holdings N.V., which was completed on 1 November. However, GE must maintain a minimum balance of about $11 billion to manage its industrial operations. We expect $4.3 billion of industrial free cash flow this year, after dividends. Moreover, GE has $15 billion of committed and available revolving credit facilities.

The company's credit quality continues to be negatively affected by effects of the coronavirus pandemic on the Aviation segment as well as the very protracted recovery in financial performance at Power and Renewable Energy. Our negative outlook also considers the planned separation of Healthcare at a time when GE is reliant on considerable, yet uncertain, improvements in earnings and cash flow to execute the planned debt reduction in 2022 and 2023 in connection with the exit of GE Capital.

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# Hanesbrands' refinancing extends maturities, lowers debt and interest cost, a credit positive

*Originally published on 09 November 2021*

On 4 November, Hanesbrands, Inc. (Hanes, Ba2 stable) announced that it will refinance its existing senior secured credit facility (consisting of a $1 billion revolver and $609.4 million term loan-A outstanding) in the fourth quarter of 2021. In conjunction with the refinancing, Hanes intends to redeem its $700 million 5.375% 2025 senior notes using proceeds from the new credit facility and cash on hand.

The transaction is credit positive because it will reduce debt and extend the company's debt maturity profile as it existing credit facility matures 15 December 2022. The transaction will also save approximately $35 million annually in interest and other expense, per the company's estimates.

Hanes' credit profile reflects governance considerations including our expectation that its financial strategy will remain conservative, with a focus on reducing debt and leverage while executing its multiyear growth strategy (Full Potential Plan). The credit profile also accounts for Hanes' significant scale in the global apparel industry, its well-known brands and leading share in the inner-wear product category. Its double-digit operating margins reflect product innovation, a low-cost supply chain and the company's ability to successfully leverage its brands. Liquidity remains good, supported by the likelihood that cash, free cash flow and revolver availability will amply cover cash flow needs, and that its cushion under its financial covenants will remain comfortable. Hanes' credit profile is constrained by its significant, but improving, customer concentration (i.e., its largest customer accounted for around 15% of its 2020 total net sales) and its exposure to volatile input costs such as cotton, which can have a meaningful and unfavorable effect on earnings and cash flows.

We expect Hanes' performance will continue to improve, that its financial strategy will remain focused on reducing debt and leverage, and that liquidity will remain good

Headquartered in Winston-Salem, North Carolina, Hanesbrands is a manufacturer and distributor of basic apparel products under brands that include: Hanes, Champion, DIM, Maidenform, Bali, Bonds and Playtex, among others. We expect pro forma revenue, excluding discontinued operations, to exceed $6.7 billion in 2021.

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# Suzano's Cerrado pulp plant expansion enhances scale without affecting leverage

*Originally published on 10 November 2021*

On 5 November, Suzano S.A. (Baa3 stable) updated details on its Cerrado pulp plant expansion project after receiving final board approval. The new pulp plant, located in the Brazilian state of Mato Grosso do Sul, will add 2.55 million tons of hardwood pulp capacity, increasing Suzano's annual capacity to 13.55 million tons. The credit-positive expansion will enhance Suzano's scale and efficiency without materially affecting leverage.

The company set the start date for the new plant for the second half of 2024, affirmed projected industrial capital spending of BRL14.7 billion ($2.7 billion) and added BRL4.6 billion ($836 million) of investment in land, forests and logistics. Suzano's board initially approved the project in May 2021, conditioned on Suzano complying with financial policies setting maximum leverage (net debt/ EBITDA) at 3.5x during periods of expansion and successfully concluding negotiations to acquire equipment. The increased scale of the new plant is likely to increase Suzano's overall efficiency and reduce cash costs, which are expected to be around BRL500/ton ($91/ton) for the first forestry cycle. Suzano reported cash costs of BRL711/ton ($129/ton) for the third quarter of 2021.

Suzano projects its capital spending at BRL6.2 billion this year, up from BRL4.9 bilion in 2020. The total includes BRL1 billion for Cerrado, or around 5% of the total project cost. The bulk of the project's capital spending – around 75% of the total – will be disbursed in 2022 and 2023.

Funding for the project will come from currently available cash and cash flow from operations from 2021-24. Suzano has ample liquidity to fund the expansion, supported by a cash balance of BRL18.7 billion and a $500 million committed credit facility (BRL2.7 billion) fully available at the end of the third quarter of 2021. With bleached eucalyptus kraft pulp prices this year averaging $650/ton, Suzano will generate free cash flow of at least BRL10 billion this year. We expect pulp prices to continue to steadily decline from recent peak levels as pulp producer inventories increase with weaker demand from China and new supply enters the market in 2022.

Suzano's total leverage, as measured by debt/EBITDA (including our standard adjustments), was 3.8x for the 12 months to 30 September 2021. We expect leverage to decline to 3.2x at the end of this year, assuming $650/ton average pulp price. For 2022 and 2023, leverage is likely to remain below 3.0x, even after incorporating the higher capital spending and lower average pulp prices for the period of about $546/ton. Suzano has a comfortable debt amortization schedule, with around BRL11 billion of debt maturing during the 2021-24 expansion period. Simultaneously, the company is also constantly working on liability management strategies to enhance its liquidity and reduce refinancing risks.

The Cerrado project will add to a pipeline of pulp expansions in Latin America, many of which will start in late 2021 and in 2022. The projects include Bracell Limited's new mill, which started operations in early October and will ramp up to 2 million tons of capacity for hardwood pulp/dissolving pulp in 2022; Celulosa Arauco y Constitucion S.A.'s (Baa3 stable) MAPA project, which will add 1.27 million tons on a net basis in the first half of 2022; and UPM-Kymmene's (Baa1 stable) greenfield project in Uruguay, which will add 2.1 million tons of hardwood pulp capacity in the second half of 2022. The Cerrado project will likely be Latin America's only major greenfield pulp project to start in 2024.

Headquartered in Salvador, Brazil, Suzano is the world's largest producer of bleached eucalyptus kraft pulp, with annual production capacity of 11 million tons. The company is also a leader in the Brazilian printing and writing paper, paperboard and tissue markets. For the 12 months that ended September 2021, it reported BRL37.5 billion in revenue.

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# Redefine Properties proposes full consolidation of EPP, a credit positive

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On 8 November, Redefine Properties Limited (Redefine, Ba2 negative) announced that it had submitted a nonbinding proposal to the board of EPP N.V., in which it has a 45.4% stake, to take full control of the company. EPP is one Poland's (A2 stable) largest retail real estate owners and had gross lettable area of 1.2 million square metres, valued at €2.4 billion as of 30 June. Under the proposal, EPP shareholders would swap their shares in the company for Redefine shares, while Redefine would fully consolidate EPP in its financials and take full control of management and cash flow decisions. Subject to board and shareholder approvals, EPP would become an unlisted subsidiary of Redefine.

The proposed transaction is credit positive for Redefine because it would improve its business risk profile without impairing its credit ratios, increase its exposure to Poland and reduce its geographic concentration in South Africa (Ba2 negative). In addition, the transaction would not be debt-funded and Redefine's pro forma Moody's-adjusted credit ratios would remain within our rating guidance.

Funding the transaction through a share swap arrangement as opposed to raising debt is positive in our view and in line with Redefine's focus on reducing its loan to value ratio over the past 12 months. The company's adjusted gross debt-to-total assets ratio was 41.6% as of 31 August compared with 47.7% a year earlier, and we estimate a ratio of 42.5% and an adjusted fixed charge coverage of 2.2x pro forma for the proposed transaction. Both ratios would remain within our rating guidance.

Redefine's total exposure to Poland (including its European logistics platform), which is the main focus of its expansion strategy, would increase to 30% from 14% (property value) following the transaction, and EPP's business fundamentals remain sound because of the country's robust growth prospects. Poland's economy grew strongly until the start of the pandemic and we expect GDP growth of 5.2% in 2021 and 4.5% in 2022. Footfall at EPP's shopping centres has steadily increased over the past six months and retail sales are 4% above pre-pandemic levels. EPP has also kept its retail occupancy stable at 95.4% and property valuations had increased by 0.4% as of 30 June 2021.

While Redefine's business profile would benefit from further diversification into Poland, it remains significantly exposed to South Africa, whose real estate market remains difficult. Civil unrest and a slow coronavirus vaccine rollout are hampering the recovery in the real estate sector and we expect the leasing market to remain very competitive, particularly in the office sector. Pressure on portfolio value will persist because market rental growth assumptions have declined, tenant retention is uncertain and the macroeconomic environment remains weak. We expect South Africa's GDP to grow by 4.1% in 2021 but by just 1.8% in 2022. Therefore, the proposed transaction would be insufficient to warrant a delinking from South Africa's sovereign rating.

EPP had a relatively high loan to value ratio of 55.8% as of 30 June. However, the proposed transaction is conditional on the company implementing certain restructuring transactions, including disposing of property portfolios, to joint-venture companies owned by EPP and third-party investors. EPP would use the proceeds to reduce debt, strengthening its balance sheet and reducing pressure on its liquidity.

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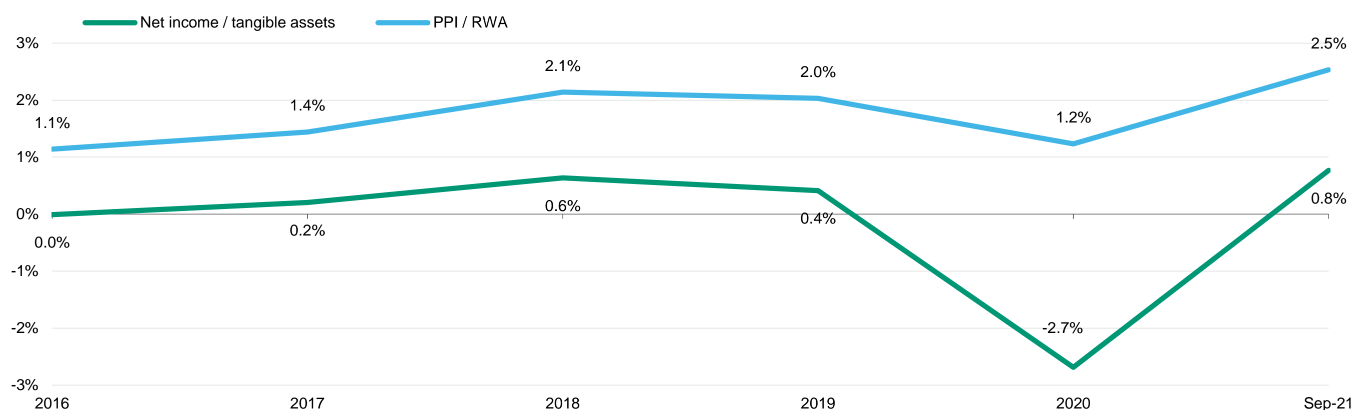
# Itaú's larger stake in Chilean subsidiary paves way for capitalization, a credit positive

*Originally published on 10 November 2021*

On 5 November, Itaú Unibanco Holding S.A. (Itaú, Ba3 stable) reaffirmed its intention to purchase the remaining shares it is entitled to in Chile's Itaú CorpBanca (A3 negative, baa3[1]) under a $1.15 billion capital injection announced in July. The reaffirmation follows Itaú CorpBanca on 4 November announcing that Brazil-based Itaú had increased its interest in Itaú CorpBanca to 53.79% from 39.22%, providing Itaú majority control. Itaú's increased stake and commitment to the upcoming capitalization are credit positive for Itaú CorpBanca because they confirm the importance of the Chilean operation for Itaú and allow Itaú to more effectively implement its disciplined risk management practices at Itaú CorpBanca.

The announcement comes as the turnaround of Itaú CorpBanca's core earnings generation starts to benefit from its restructuring (see exhibit). The increase in profitability during first nine months of 2021 contrasted sharply with deep losses in 2020 that equaled 2.69% of tangible assets. Those losses were the result of a conservative adjustment to loan-loss provisions and a onetime impairment charge of goodwill related to Itaú CorpBanca's troubled subsidiary in Colombia, Banco Itaú Colombia S.A. In September 2021, Itaú Colombia accounted for 18.7% of Itaú CorpBanca's gross loans.

**Itaú CorpBanca's core earnings have improved since 2016, even as the bank increases loan-loss provisions for its loan book**
**Ratio of net income to tangible assets versus core earnings to Moody's-adjusted risk-weighted assets**




PPI = pre-provision, pretax income; RWA = risk-weighted assets
*Sources: Itaú CorpBanca and Moody's Investors Service*

Itaú CorpBanca has undergone a long and difficult process to revamp its operations since April 2016, when Itaú merged its existing operations in Chile with the erstwhile CorpBanca, which resulted in Itaú holding a 33.58% stake in the merged bank. Itaú had to take significant measures to align Itaú CorpBanca's loan book to Itaú's risk management standards. Additionally, Itaú CorpBanca had to contend with the effects of the 2019 social unrest in Chile and the coronavirus pandemic thereafter. Low profitability since 2016 has kept Itaú CorpBanca's loss absorption low, with a tangible common equity (TCE) to Moody's-adjusted risk-weighted assets (RWA) of 7.44% as of September 2021.

The majority ownership and capital injection indicate Itaú's willingness to provide more consistent protection of senior bondholders and depositors at Itaú CorpBanca. We estimate that Itaú CorpBanca's ratio of TCE to RWA will increase by around 360 basis points to 10.8% based on September 2021 financial statements.[2]

The stake increase is also positive for Itaú because it provides the bank with direct equity control of its Chilean subsidiary, which was previously controlled through a complex shareholder agreement with the local Saieh family since 2016. The acquisition will provide

a 20-basis-point boost to our Moody's-adjusted pro forma TCE to RWAs ratio to 6.95% for Itaú as of September 2021, also a credit positive. The increase relates to lower minority interest in Itaú CorpBanca, which we exclude from our capital calculations for Itaú.

## Endnotes

1 The ratings shown are the bank's domestic deposit rating, senior unsecured debt rating if available and Baseline Credit Assessment.

2 Although the expected acquisition of minority stakes in Itaú Colombia in early 2022 will shave about 130 basis points from the bank's ratio of TCE to RWAs, Itaú CorpBanca's board of directors in July announced that they were committed to a lower dividend payout and a moderate growth strategy.

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# Increasing credit weakness in state-guaranteed loans is credit negative for Spanish banks

On 4 November, the Bank of Spain published data showing that 41% of loans with pandemic-related state-guarantees extended their maturity or their initial principal payment holiday period (or both), in accordance with regulations implemented in November 2020. The data, included in the latest edition of the Bank of Spain's biannual Financial Stability Report, reflects credit weakness among corporate borrowers that resorted to the state-guaranteed programs and it may result in an increase of problem loans once the principal payment holiday periods expire, beginning in second-quarter 2022.

Initially granted with a maximum 12-month principal payment holiday period and up to five years maturity, the government relaxed the repayment conditions for guaranteed loans in November 2020 to prevent strains on corporate liquidity. The changes (Royal Decree law 34/2020) allowed a loan principal payment holiday extension of up to 24 months and an extension of the loan maturity of up to eight years. The bulk of the borrower applications to take advantage of the legal changes were in April and May, meaning that the financial burden on affected borrowers will increase starting in second-quarter 2022 as the principal payment holiday periods come to an end.

Although the state would cover around 75% of the potential losses on guaranteed loans, the effect on banks could still be material given the extensive use of the public guarantee programs. As of 30 September, banks had granted €133 billion in state-guaranteed loans, or 11% of domestic private-sector loans [1] under the two main guarantee programs for 2020: a €100 billion program implemented in March to cover liquidity needs amid pandemic-related economic disruption, and a €40 billion program implemented in July to target investment project financing to boost economic recovery and employment creation.

The Bank of Spain report also showed a significant increase in the volume of state-guaranteed loans classified as stage 2 (loans whose credit risk has significantly increased since initial recognition even though no event of default has occurred) to around 16% as of 30 June from 8% as of 31 December 2020. By contrast, stage 2 loans in Spanish banks' total loan book rose only slightly to 7.4% from 7.1% over the same period, according to the European Banking Authority.[2]

The increase in stage 2 guaranteed loans may reflect different considerations because borrowers extending loan terms do not trigger a loan's automatic classification as stage 2. For example, the Bank of Spain refers to an increase in the proportion of guaranteed loans granted to customers facing difficulties in other loan exposures, while the existence of payment holidays prevents the crystallisation of credit risks on guaranteed loans in the short term. Although no breakdown of stage 2 loans has been provided, we expect a large portion of these to be in sectors most exposed to the effects of the pandemic, such as tourism, leisure and retail.

## Endnotes

1 Volume of domestic private loans as of August, latest data point available.

2 EBA data is not fully comparable with that provided by the Bank of Spain because the former is based on consolidated bank data while the second refers only to the domestic business.

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# Polish central bank raises rates, a credit positive for banks

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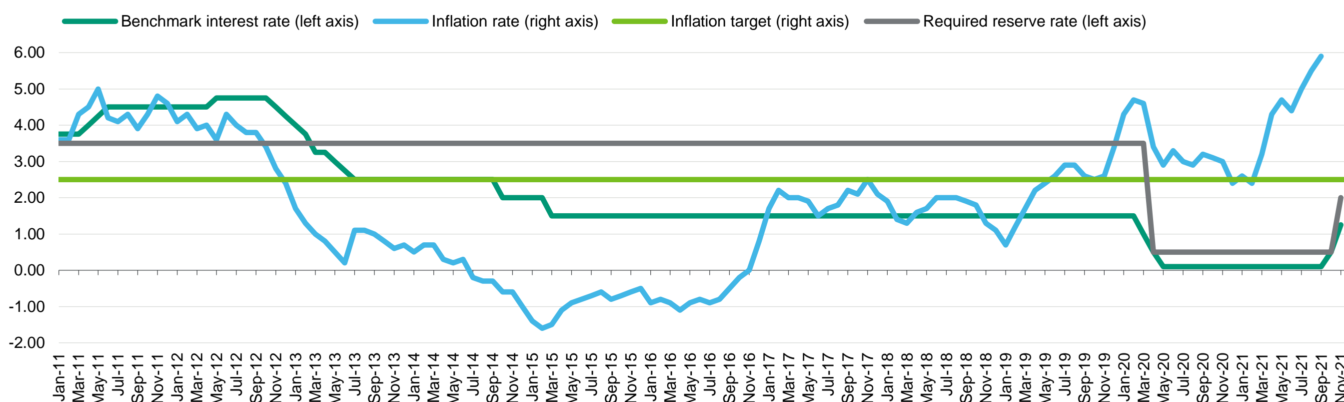
On 4 November, the National Bank of Poland (NBP) increased its key interest rate 75 basis points to 1.25%, the second rate hike in the past two months and the largest rate increase since 2000. The rate hike will improve Polish banks' net interest margins (NIMs) and boost profitability, which has broadly returned to pre-pandemic levels because of lower credit costs and increased fees and commissions.

Rate hikes in Poland have a more immediate effect on local banks' profitability than rate increases in regional peers, because most loans in Poland, including mortgage loans, have floating interest rates. Mortgage rates in other Central and Eastern European banking systems, such as Slovakia, the Czech Republic and Hungary, are predominantly fixed. With interest rates in Poland still below their pre-pandemic levels, we expect the rate hikes to be manageable for borrowers.

The NBP previously increased the policy rate by 40 basis points in October and also increased Polish banks' reserve requirement to 2.0% from 0.5%. The higher rates aim to curb inflation, which rose to 5.9% as of September (see exhibit) from 4.3% as of April this year and significantly above the central bank's 2.5% target.[1] The central bank raised its inflation expectation to between 5.1% and 6.5% for 2022 from its previous forecast in July of 2.5%-4.1%, and also raised its inflation expectation for 2023 to 2.7%-4.6% from 2.4%-4.3%. At the same time, the NBP projects real GDP growth of 4.9%-5.8% in 2021 and has dampened its 2022 growth expectation to 3.8%-5.9% from 4.2%-6.5% previously.

**Poland's central bank's aggressive tightening aims to tame inflation**




*Source: National Bank of Poland*

The rate hikes will support banks' interest income, which declined 24% in the first six months of 2021 from the year-earlier period, despite 5% asset growth over the same period. The systemwide NIM declined to 2.03% as of June 2021 from 2.52% as of December 2019,[2] before the central bank had begun quantitative easing.

Banks' NIMs were supported by a 70% reduction in interest expenses because the lower rates were immediately passed on to depositors and because banks increased their exposure to longer-maturity government bonds. Given inertia in deposits, we expect little of the cumulative rate hikes to be passed on to depositors and consequently do not anticipate a large increase in bank funding costs.

Because long-term yields have also increased following the central bank's interest rate rises, Polish banks' equity will be reduced due to the decline in the prices of bonds held as fair value through other comprehensive income.[3] As of August, 16% of systemwide assets (182% of equity) were invested in securities at fair value through other comprehensive income.

According to the central bank, a 15% decrease in the value of government bonds held in banks' portfolios measured at fair value through other comprehensive income could result in a breach of capital requirements for small banks holding a 9% combined share of banking sector assets. However, we do not expect the rate hikes to significantly reduce large banks' capitalisation. According to the country's largest bank, Powszechna Kasa Oszczednosci Bank Polski S.A. (A2 stable, baa2[4]), its capitalisation will decline by 60 basis points because of the interest rate increases, while the second-largest bank, Bank Polska Kasa Opieki S.A (Bank Pekao, A2 stable, Baa2), expects its capitalisation to decline by 30 basis points.

## Endnotes

1 Plus or minus one percentage point.

2 According to the Polish Financial Supervision Authority and the central bank.

3 Unrealised gains or losses of these securities are included in banks' equity.

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

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# Cyber breach at Robinhood is credit negative

*Originally published on 10 November 2021*

On 8 November, Robinhood Markets, Inc. revealed that intruders had accessed the account information of around 7 million of its users. Robinhood said the perpetrators obtained around 5 million email addresses and the full names of about 2 million users. The data breach adversely affects the company's reputation and will likely lead to increased costs to enhance its risk management and control functions and, potentially, respond to litigation.

Although names and email addresses were breached, Robinhood said that all Social Security and bank account numbers remained secure. Nonetheless, the incident spotlights Robinhood's weak cybersecurity defenses and its plans to expand its cryptocurrency wallet, an area that requires extensive cyber security investment.

Trading venues and brokers facilitating crypto asset markets must effectively deal with inherent operational and cybersecurity risks to maintain reliable service and secure data, or risk significant reputational damage and financial harm that could severely hurt their creditworthiness. Additionally, the retail brokerage sector is highly competitive and clients often maintain multiple accounts at different brokers. Any client losses stemming from the breach would reduce revenue and income.

Reputational damage would make it more difficult for Robinhood to attract new clients, which helps grow revenue and income, particularly in the highly profitable cryptocurrency business. But if Robinhood increased advertising spend and client incentives, it would negatively pressure profit margins. The breach could also prompt litigation and defense costs if clients allege some form of consequential damages.

Cyber reputational effects are also higher for confidence-sensitive institutions for which trust and brand equity are important competitive differentiators. In the Ponemon Institute's 2019 Cost of a Data Breach report, abnormal customer turnover was highest in the healthcare and financial institutions sectors, both of which generally collect and manage very sensitive personal data. Customer relations is a material consideration to credit in our social risks framework for financial institutions. Issues relating to this social factor can influence creditworthiness through several channels, including reputational, operational, litigation and regulatory risk.

In its July 2021 initial public offering filing, Robinhood said it expects to pay a monetary penalty of $30 million following the New York Department of Financial Services examination of the firm's cryptocurrency business segment. The examination focused on Robinhood's anti-money-laundering and cybersecurity policies and procedures for risk assessment, its weak incident response and business continuity plan and deficiencies in its application development security.

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# B3 faces competition after regulator approves new derivatives registration firm

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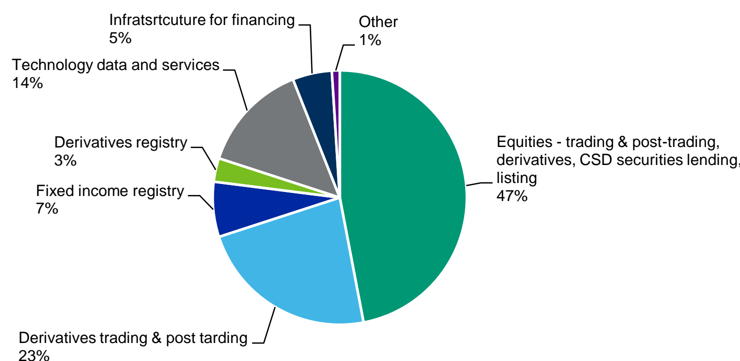
On 5 November, Brazilian's financial markets regulator Comissão de Valores Mobiliários (CVM) authorized Central de Registro de Títulos e Ativos S.A. (CRT4) to act as a derivative registry house, with CRT4 beginning its derivative registration service with non-deliverable forwards. Before CVM's action, B3 S.A. – Brasil, Bolsa, Balcao (Ba1 stable), Brazil's vertically integrated exchange, depository and clearing house for cash equities, derivatives, foreign-exchange spot and fixed-income securities, had exclusively provided these registry services in Brazil.

CRT4's entrance into the derivatives registry market is credit negative for B3 because the competition will likely lead to lower registration volume and prices for B3. CRT4's strategy is to offer competitive prices and high-quality execution through a fully digitized and agile business model.

Derivative registry contributed only 3% of B3's earnings in 2020, compared with 7% for fixed-income registry (see exhibit), and we expect that CRT4 as a derivative registry house will only have a small effect on B3's business. However, CRT4's approval signals a chipping away of B3's dominant market position, and the high levels of profitability that come with that position, which will put negative pressure on B3's revenue, a credit negative. The approval is also an indication that technology is gradually reducing barriers of entry that historically shielded B3's integrated business model.

**B3 has diverse sources of revenue because of its dominant market position**
**Revenue breakdown by line of business, full-year 2020**




*Source: B3*

CTR4 was established in May 2020 by a consortium of 31 banks,[1] including Banco ABC Brasil S.A. (Ba2 stable, ba2 [2]), Banco Daycoval S.A. (Ba2/(P)Ba2 stable, ba2), Banco BMG S.A. (B1 stable, b1) and Banco Citibank S.A. (Baa3 stable, ba2). Since then, CRT4 has been licensed to operate as a registry for term deposits and bills of exchange, and its prices for those services are as much as 50% lower than those of B3. According to CRT4, the company has a stock of BRL50 billion in registry and with derivatives registry they expect this volume to as much as triple.

As the only stock exchange operator in Brazil, B3 has a dominant position in most of its businesses, which has been key to its profitability and ability to take full advantage of Brazil's expanding and deepening capital markets and increasing trading volumes, particularly in equity markets. As of June 2021, B3 reported a pretax margin of 60% in 2020, well above its global peers' average at 46%. As with other large stock exchange operators, B3 is diversifying its revenue from its core exchange business of equities and derivatives trading, clearing and settlement to include more data-related offerings.

CRT4's potential client universe includes the 103 banks in the Associação Brasileira de Bancos, a trade association of Brazilian banks of all sizes as well as other financial institutions, financial technology firms such as XP Inc., one of Brazil's largest market-makers, and other traditional corporate banks such as Banco ABC Brasil and Banco Daycoval.

## Endnotes

1 Each shareholder has a maximum share of voting power of 5.25% to avoid concentration and ensure the company is run for all its shareholders' benefit.

2 The bank ratings shown in this report are the bank's deposit rating, senior unsecured debt rating (where available) and Baseline Credit Assessment.

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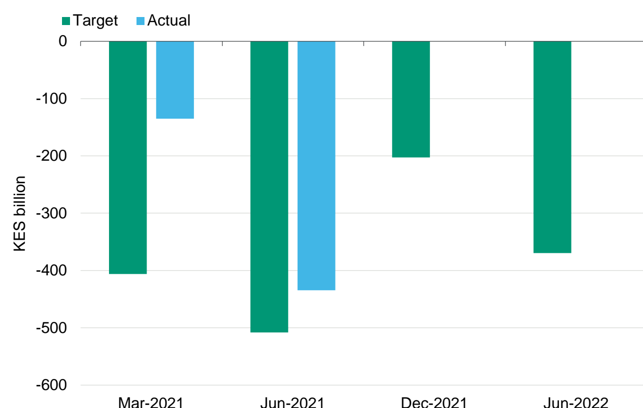
# Kenya's IMF program second review signals fiscal consolidation remains on track

On 5 November, the IMF reached a staff-level agreement to successfully conclude its second review of the Government of Kenya's (B2 negative) 38-month IMF program. Once the agreement is approved by the IMF board, Kenya will gain access to an additional $264 million under the government's Extended Fund Facility and Extended Credit Facility. The continuation of the IMF program will remain an anchor for fiscal consolidation, supporting efforts to increase revenue collection and improve the governance of state-owned corporations.

Kenya and the IMF reached agreement on a $2.4 billion financing package in February 2021, which has supported the government's fiscal consolidation agenda and mitigates immediate credit pressure stemming from liquidity risk. Even before the start of the IMF program, the government had begun to take steps to increase tax revenue and improve the governance and oversight of state-owned corporations, which faced increased financial pressure because of the coronavirus pandemic. The government has also outperformed on several IMF program targets, including the primary deficit (Exhibit 1).

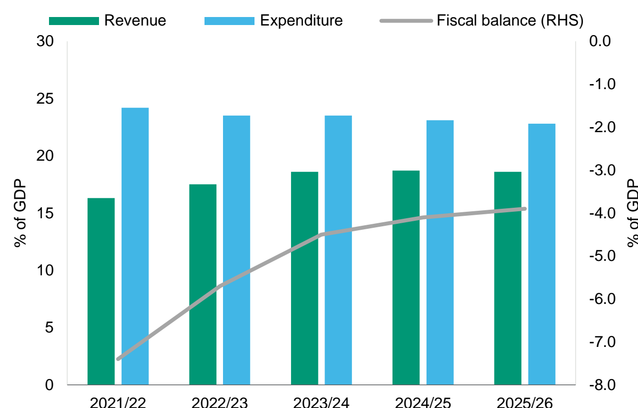
The government's fiscal projections for fiscal 2022, ending 30 June 2022, and the IMF's quantitative performance criteria are achievable, and broadly in line with our own expectations for a reduction in the fiscal deficit of about one percentage point of GDP (Exhibit 2). The IMF program provides enough flexibility through mechanisms like automatic adjusters to the primary balance target if additional support for state corporations or the purchase of additional vaccines is necessary that the government will remain on track with it over the remainder of 2021 and early 2022.

Exhibit 1
**Kenya's adherence to the IMF program's targets has supported fiscal consolidation**
**Primary fiscal balance, actual versus IMF target (KES billion)**




*Sources: IMF, National Treasury and Moody's Investors Service*

Exhibit 2
**Kenya targets a steady, multi-year fiscal consolidation to reduce the fiscal deficit to below 4% of GDP**
**% of GDP**




*Sources: National Treasury and Moody's Investors Service*

The IMF announcement of the staff-level agreement of the second review indicated Kenya's supplementary budget for fiscal 2022 would include additional resources to support state-owned enterprises. In July 2021, Kenya's National Treasury indicated 18 state corporations, excluding Kenya Airways, face financial shortfalls totaling KES70 billion annually over the next five years, equal to about 0.7% of 2020 nominal GDP. If the government remains on track with the IMF program, a slightly larger fiscal deficit in fiscal 2022 would not change our assessment of Kenya's commitment to fiscal consolidation or lead to significantly increased liquidity risk.

While compliance with the IMF's targets and the conclusion of the second review are credit positive, we continue to expect a relatively gradual pace of fiscal consolidation and see risks stemming from uncertainty over the pace of economic recovery. Political risk,

exemplified by potential fiscal slippage, slower economic growth, and social unrest ahead of the August 2022 elections, could also weigh on fiscal reforms. While Kenya has experienced unrest around elections, such as occurred in 2007, the country has seen less post-election violence since the adoption of a new constitution in 2010 with the creation of a decentralized system of governance. Even in the absence of unrest, uncertainty in the lead-up to the elections risks dampening confidence, ultimately weighing on growth. In 2017, real GDP growth slowed just before the elections and in the period surrounding the re-run election later in the year. A slowdown in investment activity or credit growth because of election-related uncertainty would pose downside risks to our growth forecast of 5.5% for 2022.

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- Regulatory investigation of potential wrongdoing at SMBC Nikko Securities is credit negative
- ANI's FDA approval of Purified Cortrophin Gel is credit positive

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- Vestas lowers 2021 profit guidance

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## Editors

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