Credit Outlook

10 February 2022

FIRST READS

- » Spirit Airlines' planned merger with Frontier Airlines is credit positive 2
- » Mali's missed payments have broader credit implications for West Africa 4

NEWS AND ANALYSIS

Corporates

- » NVIDIA cancels Arm Limited acquisition 6
- » Gannett's share repurchase authorization and term loan add-on are credit negative 8
- » Berry's $1 billion share repurchase plan is credit negative 10
- » BRF's capital increase will ease pressure on leverage, a credit positive 11
- » Ocado's 2021 revenue increased, but pre-tax losses more than tripled 13
- » China's extended peak emissions deadline is credit positive for steelmakers 14

Banks

- » GeoPhy acquisition is credit positive for Walker & Dunlop 15

Insurers

- » Historically low prices are credit negative for UK motor insurers 17

Sovereigns

- » Panama's fiscal deficit narrows more than targeted in 2021, a credit positive 19
- » Colombia's preliminary 2021 data show accelerated fiscal consolidation and declining debt 21

CREDIT IN DEPTH

- » FAQ on heightened tensions and an outright conflict between Russia and Ukraine 23

  We answer questions about the credit implications of a scenario in which tensions between Russia and Ukraine culminate in a military conflict and new sanctions on Russia.

- » Annual US consumer loan growth in Q4 accelerates, a credit negative 24

  In this pulse of the consumer report, we provide key take-aways from the New York Federal Reserve Bank's Household Debt and Credit report, which showed Q4 consumer loan growth of 7.0%, the highest since Q4 2003, a credit negative.

RECENTLY IN CREDIT OUTLOOK

- » Articles in last Monday's Credit Outlook 25

» Go to last Monday's Credit Outlook

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Spirit Airlines' planned merger with Frontier Airlines is credit positive

Originally published on 08 February 2022

On 7 February, Spirit Airlines, Inc. (B1 positive) announced that it had agreed to merge with a newly created merger subsidiary of Frontier Group Holdings, Inc, the parent company of Frontier Airlines, Inc. Spirit Airlines, Inc. will be the surviving entity of that merger.

Assuming the combination passes regulatory muster with limited, if any, conditions, the merger is credit positive for Spirit Airlines. A larger fleet and some rationalization of two route networks will provide the combined company with opportunities for improved operations. The scale and the pace of network expansion will increase, including to smaller markets. The closing of the merger will be subject to approval of Spirit's shareholders and regulatory reviews by the Department of Justice, the Federal Trade Commission and other US governmental entities. The companies believe the merger can close by the end of 2022.

Spirit's ratings, including the B1 corporate family and Ba2 rating assigned to the company's 8% notes due 20 September 2025, and its positive rating outlook are unaffected by the merger announcement.

The notes – $510 million outstanding – are secured by the company's loyalty program and brand. As an air carrier, the ownership structure of Frontier Group Holdings after completion of the merger, with no person holding more than 50% of the voting stock, will not by itself trigger a parent change of control pursuant to the indenture's terms. As a result, we expect the notes to remain outstanding following the merger. The merged company's branding and loyalty programs will be decided in the future. The terms of the 8% notes provide that any replacement loyalty program and/or brand becomes part of the collateral for the financing.

As with the many precedent US airline industry mergers since 2008, the acquired airline remains an independent operating company upon the closing of the transaction. Spirit will continue to operate with its existing airline operating certificate (AOC) until the US Federal Aviation Administration (FAA) issues a combined AOC covering both operating companies. We believe the FAA will provide the combined operating certificate between 18 and 24 months after the transaction closes. At that time, we expect a legal entity merger to occur.

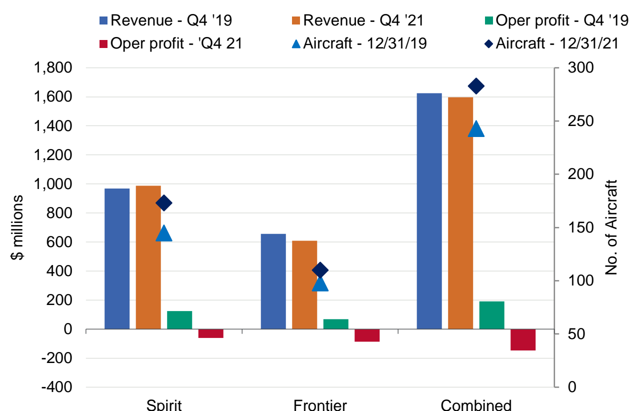
The companies expect that their larger combined fleet will provide them with better growth opportunities to expand their geographic coverage of the US, relative to them each remaining independent. The combined fleet will grow at a 12% compounded annual growth rate between 2021 and 2026, given each company's current aircraft order book. The companies argue that they will also be better able to bring service and low fares to more medium- and smaller-size cities, which they presented as a factor that regulators should deem favorable in considering whether to approve the merger.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.

Exhibit 1

Revenue recovered sharply in Q4 compared with pre-pandemic levels; operating profit improvement will trail by six to nine months

The airlines' fourth-quarter 2019 and 2021 revenue and operating profit, and year-end fleet count

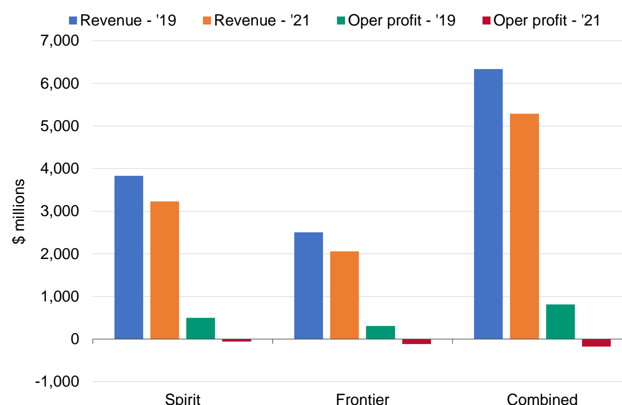


Source: Companies' Q4 2021 earnings releases

Exhibit 2

With fleet growth and a continued recovery from the pandemic, pro forma revenue will exceed $7 billion in 2022

Revenue and operating profit for 2019 and 2021



Source: Companies' Q4 2021 earnings releases

The companies disclosed projected run rate "operating" synergies of $500 million per year, $100 million of which would be cost synergies. The companies also stated that "Consumers win with $1 Billion in annual savings." We believe this reference portrays the companies' estimate of the magnitude of the difference between the combined company's fares and those of other airlines in the markets in which Frontier/Spirit will enter.

Notwithstanding the companies' lower unit costs among the US airlines, we believe the potential demand in markets with typically smaller populations will complicate the financial success on such routes. Larger aircraft size is the typical impediment to sustained strong financial results when serving smaller markets, because it is more difficult to consistently achieve high enough load factors at pricing that promotes sustained profitability. This is the case particularly in operating models such as Spirit's and Frontier's, which rely on maximizing daily utilization – flight hours – of the fleet. With no change to aircraft size because of the merger, we believe there is greater execution risk to achieving success on this component of the combined company's strategy.

Consolidation in the US airline industry has been credit positive for the participants and has strengthened the industry overall. Between 2008 and the onset of the COVID-19 pandemic, the credit quality of the US airlines materially strengthened, with the median rating of the US airlines improving to Ba2 from B3 during this period. The competitive benefits of a more concentrated industry and operating strategies that prioritized earning profit and acceptable returns on capital instead of maintaining or gaining market share were the key drivers of the improvement. Continuation of the return on capital emphasis will be needed to sustain the improvements.

Frontier Group Holdings shareholders will own the majority of the equity of the post-merger enterprise. The transaction will be mostly a stock-for-stock merger. Spirit shareholders will receive 1.9126 shares of Frontier Group Holdings shares for each of its shares, plus $2.13 in cash, for an aggregate value of $25.83 per Spirit Airlines' share. The merger values Spirit's equity at $2.9 billion.

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Mali's missed payments have broader credit implications for West Africa

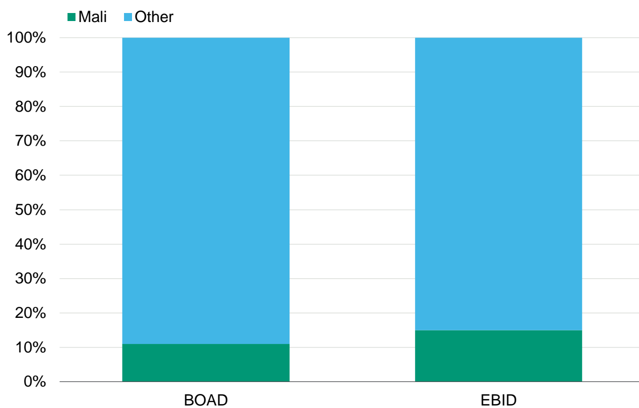
Originally published on 07 February 2022

On 6 February, the Government of Mali (Caa2 review for downgrade) missed CFA1.677 billion ($2.8 million) of payments on commercial debt, according to UMOA-Titres, the agency in charge of helping West African Economic and Monetary Union (WAEMU) countries issue debt on capital markets. Mali missed payments since 28 January after sanctions imposed by the Economic Community of West African States (ECOWAS) earlier in the month blocked all payments through the payment systems of the Central Bank of West African States (BCEAO).[1]

The accrual of payment arrears prompted us to downgrade Mali's rating and place it on review for further downgrade on 4 February. Furthermore, Mali's inability to service debt payments as long as sanctions remain in place risk broader implications for West African sovereigns, multilateral development banks and financial institutions operating in the region.

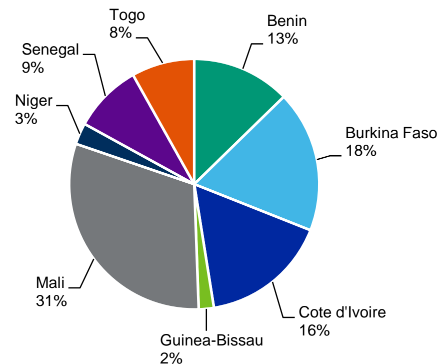
Loans to Mali account for between 10% and 15% of total loans for the West African Development Bank (BOAD, Baa1 negative) and the ECOWAS Bank for Investment and Development (EBID, B2 stable), and the majority of these loans are to the sovereign (see Exhibit 1). Arrears will accrue for as long as payments to these multilateral development banks (MDBs) are blocked due to sanctions, adding to asset-quality pressures triggered by the pandemic and heightened political instability in the region. Similarly, commercial banks in Burkina Faso and Côte d'Ivoire (Ba3 stable) hold Malian local-currency debt worth 3.7% and 1.4% of their assets, respectively (see Exhibit 2).

Exhibit 1
Some regional MDBs have large exposures to Mali
Share of gross loans, year-end 2020



Sources: BOAD, EBID and Moody's Investors Service

Exhibit 2
A number of the region's banks hold Malian local-currency debt
Holdings of Malian regional debt issued by auction as of Q3 2021



Sources: UMOA Titres and Moody's Investors Service

Meanwhile, Mali's missed payments increase uncertainty around the application of WAEMU's default-prevention mechanism, the Financial Stability Fund (FSF) residing at the BCEAO. The FSF was created in May 2012 by regional finance ministers to avoid another technical default like that incurred by Côte d'Ivoire during its political upheavals in 2010-11 and the ensuing contagion to the region.[2] While BCEAO stepped in to ensure scheduled payments on Mali's outstanding debt instruments during the initial sanctions in August and September 2020 following the coup d'etat, the absence of the backstop in this instance diminishes the credit support ascribed to this element of WAEMU membership, with implications for potential contagion to other WAEMU members and increased investor risk differentiation among member countries along political risk and institutional quality considerations.

Meanwhile, the sanctions themselves applied to Mali are also likely to have knock-on effects for its neighbors. Senegal (Ba3 negative) and to a lesser degree Côte d'Ivoire are most exposed to trade disruption given landlocked Mali is heavily reliant on their ports. In addition, Mali is Senegal's main export market, absorbing about 22% of total exports, and 5% of Côte d'Ivoire's exports as of 2019. Although ECOWAS stopped short of applying sanctions on Burkina Faso last week and instead called for the submission of an election timeline, the sanctions against Mali are indicative of a hardening stance from the region's institutions for breaches of its rules.

A prolonged standoff could put at risk the financial support from bilateral and multilateral sources that Mali and its regional peers are reliant upon to finance the fight against violent extremism. In turn, this could worsen living standards and escalate social risks across the region, thereby fueling political event risk in the future. Moreover, the imposition of sanctions on Mali stokes anti-ECOWAS sentiment in the region, presenting a dilemma for the institution.

Endnotes

1 As of 9 February, missed cumulative interest and principal payments were CFA53 billion ($92 million).

2 In practice, the FSF resides with the regional central bank, the BCEAO, and is tasked with ensuring continued debt-service payments on regional and international markets on behalf of member countries that are exposed to temporary shocks that prevent them from meeting their financial liabilities. According to its statutes described on p.135-137, the FSF is endowed with FCFA 383 billion in seed money from the BCEAO and is funded by member contributions and by regional institutions, including BOAD.

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NVIDIA cancels Arm Limited acquisition

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On 7 February, NVIDIA Corporation (A2 stable) announced that it terminated its agreement to acquire Arm Limited for approximately $40 billion from SoftBank Group Corp. (SBG) and the SoftBank Vision Fund (together Softbank). Amid the ongoing regulatory challenges to get deal approval, Softbank has decided to pursue an IPO of Arm Limited.

The proposed transaction, the largest ever in the semiconductor industry, would have enhanced NVIDIA's growth opportunities in a variety of markets (data center, server, PC, smartphone, and emerging edge technologies), and diversified its revenue base, but its cancellation saves NVIDIA $10 billion and allows a renewed focus on the core business after 17 months of regulatory review.

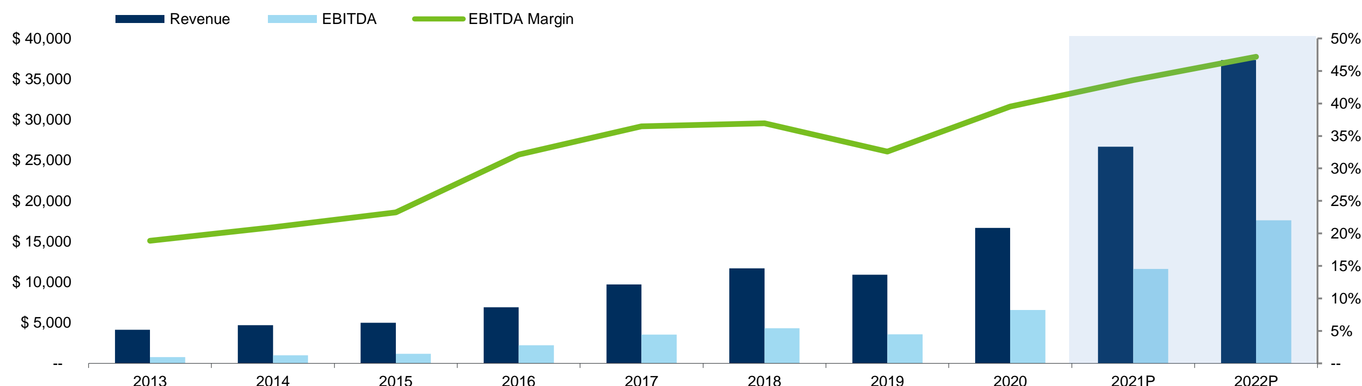
Despite ending the deal, NVIDIA's credit profile reflects the company's leading position in growing markets of visual computing, led by the gaming sector, along with the high performance data center, automotive and enterprise graphics end markets. Based on the growth of data intensive computing coupled with NVIDIA's broad range of accelerated computing offerings, we expect NVIDIA's very strong financial performance will continue over the intermediate term.

The company's growing profitability, strong cash flow, excellent liquidity, very modest leverage, and a balanced capital allocation philosophy support its rating. With over $20 billion of cash and liquid investments (even after paying a non-refundable $2 billion upon deal announcement in September 2020, inclusive of a 20-year Arm license), our projection of more than $13 billion of free cash flow after dividends over the next year, and no debt maturities until $1.25 billion due in June 2023, NVIDIA retains exceptionally strong financial flexibility. Softbank will retain $1.25 billion prepaid by NVIDIA, and the NVIDIA will retain its 20-year Arm license. NVIDIA intends to record a $1.36 billion charge in the first quarter of fiscal 2023, inclusive of the $1.25 billion prepayment at signing, because of the terminated Purchase Agreement.

The company still retains one of the strongest growth profiles in the semiconductor sector, with a diversifying revenue base. NVIDIA's gaming-based revenue has averaged 75% revenue growth over the last four quarters and comprises 45% of total revenue, down from 59% four years ago. Its data center revenue averaged 66% revenue growth over the last four quarters and comprises 41% of total revenue, up from 19% four years ago.

NVIDIA's credit profile reflects its strong profitability, cash flow, and robust liquidity that are driven by the company's strong position in growing markets of visual computing, led by the gaming sector, along with the high performance data center, automotive and enterprise graphics. Based on the acceleration of data intensive computing coupled with NVIDIA's broadening range of related offerings, we expect NVIDIA's strong financial performance will continue over the intermediate term. After growing revenue by 64% for the 12 months to October 2021, faster than the 53% in the year ending January 2021, we project revenue will grow approximately 40% in January 2023 (driven by its gaming and data center markets), while adjusted EBITDA margins move toward the mid-40% range, and free cash flow after dividends approximates $13 billion (see Exhibit 1).

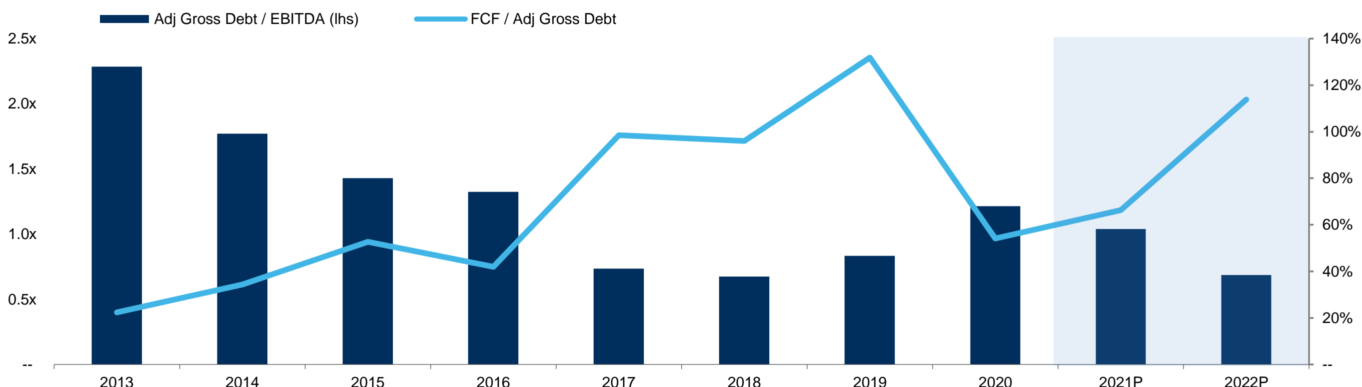
Exhibit 1
Revenue, EBITDA, and EBITDA margins continue to expand
$ in Millions



All figures and ratios are calculated using Moody's estimates and standard adjustments. Moody's Forecasts (F), Projections (P) or Estimates (E) are Moody's opinion and do not represent the views of the issuer. Years are closest to CYE.
Sources: Moody's Financial Metrics™ and Moody's Investors Service projections

We forecast a continuation of very modest financial leverage as demonstrated by adjusted gross debt to EBITDA (including a tax repatriation liability) under 1x, and free cash flow to adjusted gross debt over 100% during fiscal year ending January 2023 (see Exhibit 2).

Exhibit 2
Leverage will remain very modest



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

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Gannett's share repurchase authorization and term loan add-on are credit negative

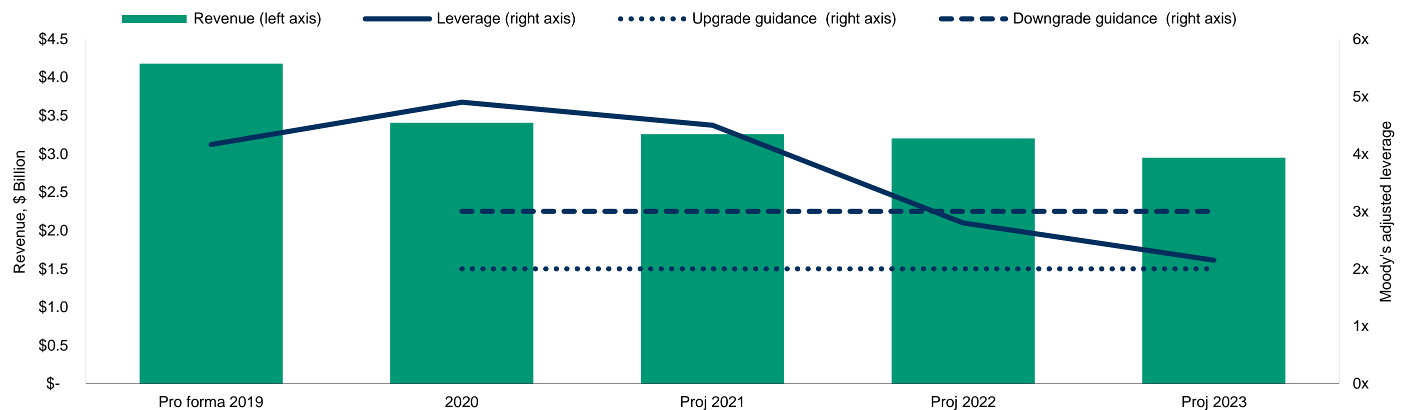
On 4 February, Gannett Co., Inc. (B3 stable) upsized its term loan by $50 million to help fund a share repurchase announced three days earlier of up to $100 million of the company's common stock. The term loan add on and share repurchase are credit negative because they increase debt and reduce the cash available for debt repayment.

Gannett will fund the share repurchases with a combination of debt ($50 million term loan add-on funded on 4 February) and balance sheet cash. The share repurchase authorization came before the company reached its own leverage target. As of the last 12 months to September 2021, Gannett's first lien net leverage (company's definition) was 1.6x, well above the company's target of under 1x.

Gannett expects it will reduce leverage over the next 12-18 months. We estimate that pro forma for $100 million in share repurchases, Gannett will end 2022 with gross debt leverage of around 2.8x (including our standard adjustments), about a quarter turn higher than our prior expectation. While slower than we originally expected, this is still a notable leverage reduction from its Moody's-adjusted debt/EBITDA of 5.3x as of the 12 months to September 2021. Gannett's balance sheet cash of $141 million as of 30 September and expectation of free cash flow generation over $150 million this year can sufficiently absorb the currently authorized share repurchases and basic cash needs, including mandatory debt service, capex, working capital and pension contributions.

Gannett's revenue is pressured by the secular decline in its advertising- and print-focused activities, and the company's high leverage, defined as Moody's-adjusted gross debt/EBITDA (see exhibit). We do not expect the structural pressure on Gannett's print advertising and print circulation to ease in the future as demographics evolve and consumers' tastes continue to gravitate toward digital media. The company is transforming its business model by diversifying revenue sources with growth potential from digital properties to offset the secular decline in traditional print advertising and circulation.

Though declining, leverage is still high considering secular business risks



Pro forma 2019 represents legacy New Media's results through the date of the acquisition in November 2019, plus the consolidated company's results of operations for the rest of 2019. Proj are Moody's projections.
Source: Gannett's SEC filings, Moody's Financial Metrics™

Gannett's credit profile benefits from the company's position as the largest owner of daily newspapers in the US and community newspapers in the UK, good free cash flow generation and management's focus on repaying debt. We expect that Gannett will maintain adequate liquidity as it manages its share repurchase program and will use retained cash flow to reduce debt, bringing its Moodys-adjusted leverage below 3x by year-end 2022.

Headquartered in McLean, Virginia, Gannett is the largest owner of daily newspapers in the US and community newspapers in the UK. Gannett is also the owner of national USA Today publication.

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Berry's $1 billion share repurchase plan is credit negative

Originally published on 07 February 2022

On 3 February, Berry Global Group Inc. (Ba1 CFR stable), a manufacturer of rigid and flexible packaging products, announced that its board of directors authorized a share repurchase of up to $1 billion. The company plans to repurchase at least $350 million of stock during the current fiscal year ending September 2022, and complete the program over the next two to three fiscal years. Berry has already repurchased $50 million shares during the first quarter that ended in December 2021.

The buyback is credit negative because it will reduce future free cash flow available for debt repayment. The $350 million of annual repurchases, which replaces the existing program with similar amount for 2022, will consume more than a third of the about $900 million of annual free cash flow Berry typically generates, and the program extends for the next two to three years. Moreover, during the first quarter ended in December 2021, Berry's cash flow from operations plunged to negative $304 million from $315 million recorded a year ago because of higher working capital requirements reflecting a seasonal inventory increase.

However, we expect the buyback's negative effect on Berry's credit quality will be limited because the company will likely pace its annual buybacks to control total debt and leverage. Berry indicated publicly it will target leverage at 3.0x-3.9x on a net basis while executing the repurchase program. Based on announced first-quarter results to December 2021, we estimate Berry's net leverage was around 4.4x on a reported basis for the 12 months to December, exceeding the target. Leverage will still likely recover as Berry passes higher base costs on via higher prices and improves EBITDA toward the end of this fiscal year. During the fiscal first quarter, Berry's reported EBITDA fell about 15% from what it was a year ago.

We also expect the company's cash flow to improve with seasonality factors and its profit recovery, reflecting cost pass-through. Berry is targeting free cash flow for fiscal 2022 of $900 million-$1 billion, in line with historical levels.

Berry's total debt declined to $9.4 billion in December 2021, from a peak of $11.4 billion in September 2019, on a reported basis. Berry may still make small tuck-in acquisitions, but we expect the company to adjust its share repurchase to manage total spending and keep its leverage in line with the target.

Similarly, we expect Berry's gross leverage to decline toward the end of this fiscal year. For the 12 months to December 2021, we estimate leverage at around 4.8x including our standard adjustments, which exceeds our guidance for downgrade at 4.25x. But we expect the gross leverage to improve to 3.5x-4.25x, within the range for the current rating, as cost pass-through takes effect on profit and total debt declines.

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BRF's capital increase will ease pressure on leverage, a credit positive

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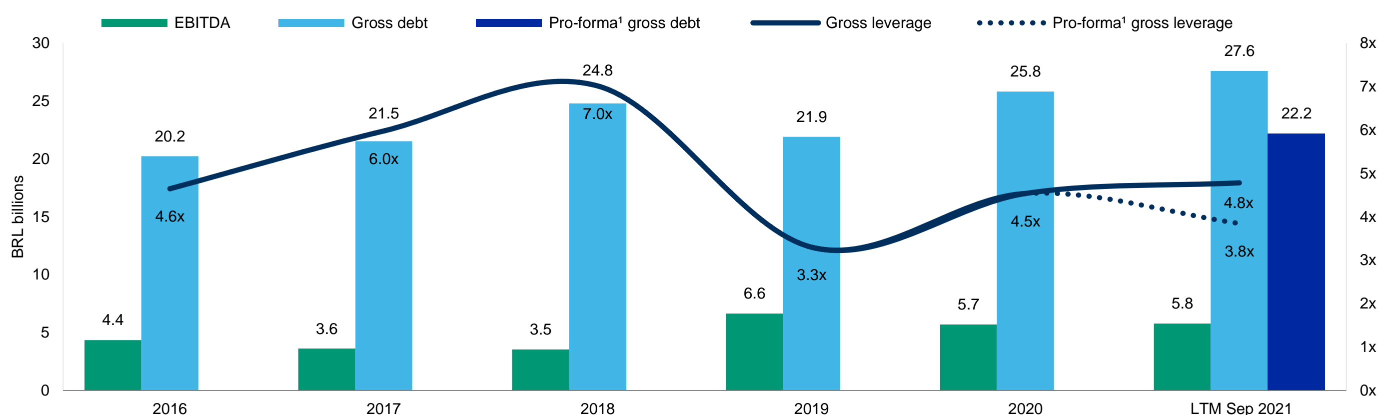
On 4 February, BRF S.A. (BRF, Ba2 positive) completed a public offering of 270,000 shares, including 11,250,000 American depositary shares (ADS) at BRL20 per share and $3.79 per ADS, raising a total of BRL5.4 billion. The credit-positive capital increase will strengthen BRF's capital structure and materially reduce the debt that it will need to raise to carry on its expansion plan and will reduce leverage.

Inflationary pressure on raw materials and energy costs will challenge the company's ability to improve margins this year, however the pressure should ease during the year. Even though BRF has a relatively good track record in keeping cost increases below inflation and passing price increases to customers, EBITDA margins declined to 12.5% in the 12 months that ended September 2021 from a peak of 19.9% at year-end 2019.

In December 2020, BRF announced a growth strategy that includes about BRL55 billion in capital expenses through 2030, evenly distributed in three periods: 2021-23, 2024-26 and 2027-30. The strategy combines both organic and inorganic growth and targets maximum leverage of 3x (net debt/EBITDA), but which can be temporarily increased to 3.5x during the investment cycle. The capital increase will allow BRF to pursue its growth strategy while maintaining leverage within the ranges established in its financial policy.

BRF indicated that the proceeds of the capital increase will be used to strengthen the company's capital structure and/or allocated to growth or strategic investments. On a pro-forma basis, assuming that the full amount of proceeds (BRL5.4 billion) is used to reduce debt, leverage, as measured by total Moody's-adjusted debt to EBITDA, would decline to 3.8x in the 12 months to September 2021, from the actual 4.8x in the same period (see exhibit).

Capital increase will ease pressure on capital structure



Pro-forma debt including BRL5.4 billion capital increase.
All figures and ratios are calculated using Moody`s estimates and standard adjustments.
Sources: Company data and Moody's Investors Service

Despite its current high leverage, BRF maintains good liquidity and had a cash balance (including short-term investments) of BRL7.2 billion at the end of September 2021. Liquidity is enhanced by BRL3.0 billion available under committed credit facilities (BRL1.5 billion available through December 2022 and BRL1.5 billion available through October 2023) with Banco do Brasil S.A. (Ba2 stable).

BRF's ownership structure (as of September 30, 2021) is diffused, with Marfrig Global Foods (Ba3 positive) holding 31.66% of total shares. Marfrig announced that its board of directors approved its participation in BRF's public offering in the proportion of its current share in BRF's capital. Additionally, pension funds Fundação Petrobras de Seguridade Social (Petros) and Caixa de Previdencia dos Funcionários do Bando do Brasil hold 13.14% of BRF's total shares, and JPMorgan Chase & Co (A2 stable) and Kapitalo Investimentos

Ltda together hold 12.17%. ADRs comprise 19.81% of total shares, while board members and managers hold about 0.77% of total shares, with a remaining free float of 28.98%.

BRF S.A. is one of the largest food conglomerates globally and posted consolidated net revenue of BRL46 billion ($8.6 billion, at an average exchange rate) for the 12 months to September 2021. Processed food and food services, which typically generate higher and less volatile margins than the chilled and frozen protein export business, contributed 51% to net revenue in the same period. The company operates over 39 industrial facilities and 41 distribution centers in the world, exports to almost 120 countries and is a leader in global poultry exports.

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Ocado's 2021 revenue increased, but pre-tax losses more than tripled

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On 8 February, UK online grocer Ocado Group plc (B2 stable) said in its fiscal 2021 results, which ended 28 November, that retail sales increased at good pace during the period while its technology revenue was booming. However, despite the strong top line growth, Ocado's technology investments resulted in a pre-tax loss of £176.9 million, up from £52.3 million in fiscal 2020, and company guidance suggests that this trend will remain in place in fiscal 2022, a credit negative.

Ocado's retail revenue in fiscal 2021 was £2.3 billion, up 4.6% from fiscal 2020 and 41.5% higher than fiscal 2019 (pre-pandemic). The top line was supported by the International Solutions business, which provides automation services to retailers outside the UK, whose revenue increased to £66.6 million versus £16.6 million in the prior year.

The company continued to see good demand for its technology solutions: the number of live sites doubled, five new customer fulfilment centres (CFCs) were opened, including the first two in the US, bringing the total number of live CFC sites to 13, with six more to open in 2022. Ocado's technology is well received by customers whose operating costs fall as a result of its adoption. Ocado recently claimed the introduction of a “game-changing” innovation which is expected to further transform partner economics, that is, further reducing the cost of their online deliveries.

Ocado's own operating costs continue to rise. Group reported fiscal 2021 EBITDA was £61.0 million versus £73.1 million in 2020. The decline was due to additional investments in technology capability and other central costs more than offsetting higher EBITDA in UK Solutions and Logistics and Ocado Retail. The trebling of the loss before tax to £176.9 million mainly reflects higher investments in Ocado's Solutions business required for the roll out of Ocado Smart Platform (OSP). On a pre-exceptionals basis, pre-tax losses increased to £219.7 million from £148.6 million in fiscal 2021. We estimate Ocado's Moody's-adjusted EBITDA at £93 million in fiscal 2021, which is below our expectations.

The company had £1.5 billion of cash on the balance sheet as at 28 November, supporting significant UK and International growth plans. With gross debt of around £1.8 billion and no near-term maturities following the refinancing last October, Ocado's liquidity is adequate and will allow it to continue pursuing its investment plans over the next two years before it will need to refinance. The first notes maturity is £600 million senior unsecured convertible bonds is due December 2025. Although liquidity remains adequate at this stage, leverage is increasing: we estimate leverage (Moody's-adjusted gross debt/EBITDA) of around 19x at the end of November, compared to 12x in fiscal 2020 and 9x last May.

Management's guidance for fiscal 2022 is for a return to mid-teens revenue growth, potentially improved EBITDA margins for Ocado Retail, strong EBITDA growth (~50%, so a slow down from the previous year) in UK Solutions & Logistics, and flat results in International Solutions. Total capital expenditure is expected to be around £800 million driven by accelerating roll out of OSP worldwide, compared to £680.4 million in 2021 and £525.6 million in 2020. Ocado continues to target Solutions deals, which it said “would generate additional cash fees but would negatively impact short-term profits.”

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China's extended peak emissions deadline is credit positive for steelmakers

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On 7 February, China's Ministry of Industry and Information Technology (MIIT), the National Development and Reform Commission (NDRC) and the Ministry of Ecology and Environment jointly issued guidance that extended the deadline for the steel sector to reach peak carbon emissions by five years. They announced 2030 as the new target, compared with an earlier deadline of 2025.

The extension is credit positive for China's steelmakers because it allows them to better balance decarbonization plans and their financial profiles. An extra five years can imply slower investments in decarbonization, allowing steelmakers to spread out such investments to avoid incurring substantial amounts of such capital expenditure in the short term. This is especially beneficial for smaller steelmakers that have funding and technology constraints in making the transition to decarbonization.

The steel sector is one of the main contributors of carbon emissions in China and is estimated to have accounted for around 15% of the country's total carbon emissions in recent years. The industry therefore plays a critical role in China's commitment to become carbon neutral and the extension reflects the difficulties of reaching that goal.

The extension comes as current elevated raw material costs are compressing margins for steelmakers and the sector is seeing pressure from a potential drop in demand from weakness in the property market, which is a main downstream sector. With financial burdens related to decarbonization investments eased in the short term, steelmakers can now allocate more financial resources to developing advanced technology and higher-margined steel products.

We expect the relaxation in the deadline will not have a material impact on the country's overall goal to achieve a carbon peak by 2030 because the government will continue to implement strict control over steel capacity and production while encouraging environmentally-friendly projects. Such efforts, along with the extension, will also help support stability in steel supply and prices.

The updated guidance also calls for an increase in output from electric arc furnaces (EAF) to account for over 15% of China's total crude steel production by 2025. This means steelmakers will still need to invest in EAF technology, creating a potential challenge for smaller steelmakers in the medium term. In 2020, China's EAF capacity was only around 9%, according to the latest available data from the World Steel Association. The basic oxygen furnace (BOF) method, which is much more carbon-intensive than EAF, contributed the remaining 91% share. To promote the gradual increase in EAF capacity, the guidance calls for annual steel scrap consumption to reach over 300 million tonnes by 2025.

The guidance states that more than 80% of the country's steel capacity should complete ultra-low emissions reform by 2025 to aid the sector's carbon peak by 2030. It also continues to call for consolidation and restructuring in the sector.

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GeoPhy acquisition is credit positive for Walker & Dunlop

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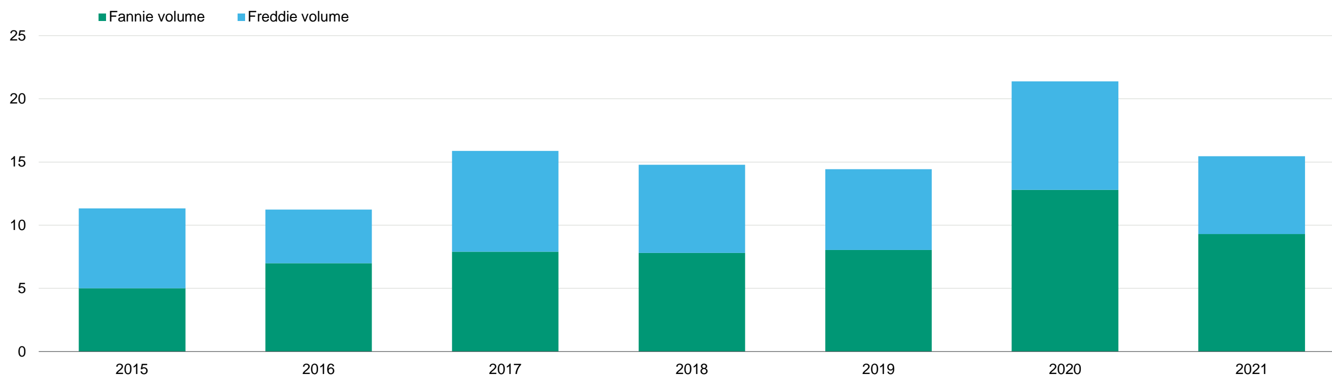
On 7 February, Walker & Dunlop, Inc. (W&D, Ba1 stable), a US commercial real estate (CRE) finance company, announced the acquisition of GeoPhy B.V., a Netherlands-based technology firm that provides data and analytics solutions to the CRE industry. The deal is credit positive for W&D because it will allow the firm to continue to drive growth in its small balance lending (SBL) originations, leveraging GeoPhy's technological capabilities.

The acquisition will cost W&D a relatively modest amount at the outset, $85 million in cash (compared with over $300 million in unrestricted cash as at 31 December 2021), with potential earnout costs of up to $205 million payable over the course of the next four years. However, the benefits from improvement in performance in certain business segments, should the maximum earnout be realized, will outweigh the expected costs of earnouts over time.

W&D specializes in originating and servicing loans secured by multifamily properties guaranteed by US government-sponsored enterprises Federal National Mortgage Association (Fannie, Aaa stable) and Federal Home Loan Mortgage Corporation (Freddie, Aaa stable), collectively, the agencies. The firm has benefited in recent years from growth in overall agency multifamily volume and gains in market share for agency multifamily financing (see exhibit). GeoPhy's technology will help W&D expand its product offerings into the agencies' SBL programs, driving higher origination volumes. Of the potential $205 million in earnouts, $155 million will be tied to growth in SBL mortgage banking gains and originations.

W&D has significantly grown transaction volume over time
W&D Fannie and Freddie multifamily origination volume ($ billions)



Sources: Company reports and Moody's Investors Service

GeoPhy is W&D's current partner in its appraisal business, Apprise, which is structured as a joint venture between the two firms. The familiarity between the two firms minimizes the potential for integration risks, in our view. Part of the earnout will be tied to growth in Apprise's revenue. The joint venture reported $9 million in revenue in 2021, which will need to improve to $30 million by 2025 to unlock the low end of the associated earnout. The sellers of GeoPhy may earn up to $50 million in earnouts if Apprise's annual revenue improves to $75 million by 2025.

With $710 million in tangible equity and $4.2 billion in tangible assets reported at 31 December 2021, we do not expect the acquisition to have a significant impact on Walker & Dunlop's capital adequacy. While capitalization may fluctuate at times conforming with origination volumes, we expect the company to continue to maintain solid capitalization.

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Historically low prices are credit negative for UK motor insurers

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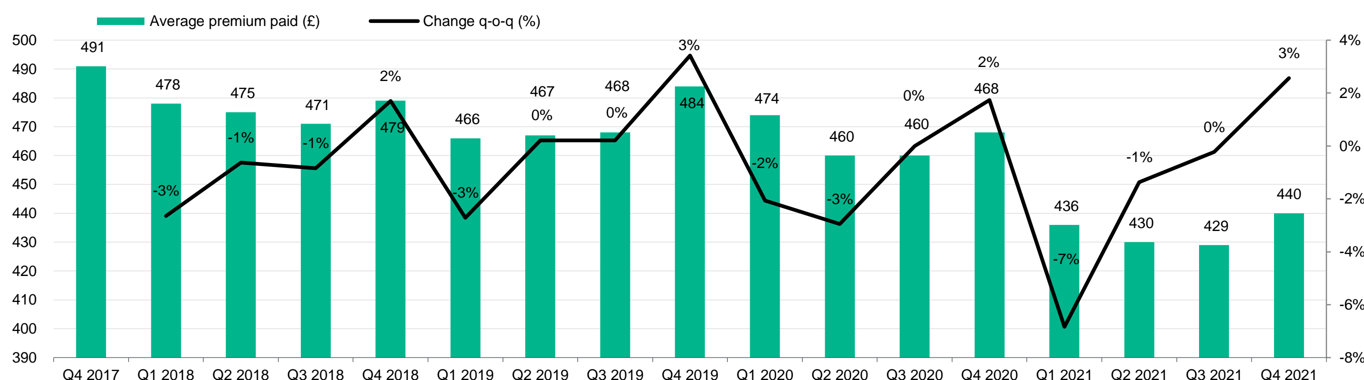
On 5 February, the Association of British Insurers' (ABI) latest Motor Insurance Premium Tracker revealed that the average comprehensive UK motor insurance premium during 2021 fell 7% versus 2020. Although the average premium rose 3% during fourth-quarter 2021 versus the third quarter, it was 6% lower than in the same period a year earlier. The year-on-year decline confirms that UK motor insurers, already pressured by rising claims inflation, face pricing and profitability headwinds moving into 2022.

Low premiums in 2021 reflected not only lower-than-normal motor claims frequencies as a result of lock-down restrictions, but also the very competitive nature of the UK motor market. We believe a combination of intense competition and high underlying claims inflation will continue to challenge the underwriting results of UK motor insurers, including Aviva Insurance Limited, (Insurance Financial Strength (IFS) Aa3 stable), Direct Line Insurance Group plc, whose main operating company is UK Insurance Limited (IFS A1 stable), AXA Insurance UK plc (IFS, Aa3 stable), RSA Insurance Group Limited, whose main operating company is Royal & Sun Alliance Insurance Limited (IFS A2 stable) and Admiral Group Plc. The UK personal lines insurance sector faces additional pricing pressure from the UK Financial Conduct Authority's (FCA) measures to prevent UK home and motor insurers from charging existing customers more than new ones.

According to the ABI, the 3% gain in UK motor insurance prices in the fourth quarter compared with the previous three months followed a 13% decline over 15 quarters beginning in fourth-quarter 2017 (see exhibit). The average annual comprehensive motor premium paid over 2021 as a whole was £434, down from £465 in 2020, and the lowest level in six years.

The UK average comprehensive motor premium rose in Q4 2021 but fell during 2021 as a whole
Change in the average premium paid for comprehensive motor insurance in the UK



Change quarter on quarter refers to the change in price from the previous quarter.
Sources: Association of British Insurers (ABI) and Moody's Investors Service

Over the first nine months of last year, the drop in motor insurance prices partly reflected lower claims frequencies as a result of lockdown restrictions, which led to a downward adjustment of premiums. Pandemic-related restrictions also reduced new car sales and new driver numbers, putting additional pressure on average premiums. The increase in premiums during the fourth quarter may reflect insurers' efforts to prepare for a return to a more normal claims frequencies at a time when claims costs are already rising. However, price increases during the final three months of the year have previously gone into reverse the following quarter (e.g., in 2018, 2019 and 2020).

While motor insurers' loss ratios (claims as a percentage of premiums) benefited during 2021 from subdued claims frequency, the consequent decline in their total claims costs will make it somewhat harder for them to justify price increases in 2022. This will exacerbate already intense competition in the UK motor sector.

With underlying claims inflation rising as more expensive in-car technology pushes up repair costs, resistance to price increases will put motor insurers' underwriting performance under pressure. The ABI states that between 2015 and 2020, the average payout for damage to policyholders' vehicles increased by 59%, and the average paid to third parties by 32%. The price improvement during the fourth-quarter will only partly compensate for higher claims inflation[1] and still low interest rates.

The UK personal lines insurance sector faces additional pricing pressure from the FCA's measures to prevent UK home and motor insurers from charging existing customers more than new ones. Under the new rules, insurers must from 1 January 2022 offer renewing policyholders a price that is no higher than they would pay as a new customer through the same sales channel, unless their risk profile has deteriorated.

The industry could attempt to counteract the loss of revenue by raising prices for first-time customers, but we believe intensely competitive conditions in the UK personal lines insurance markets will make this difficult.

Endnotes

1 Direct Line Insurance Group disclosed in its Q3 2021 trading update that claims severity inflation was slightly above its 3%-5% medium-term expectations

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Panama's fiscal deficit narrows more than targeted in 2021, a credit positive

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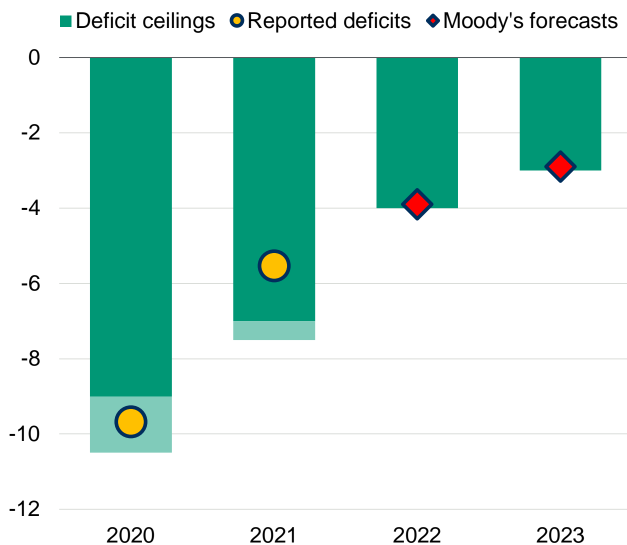
On 7 February, Panama's (Baa2 stable) Ministry of Finance reported that the central government's 2021 preliminary fiscal deficit declined to 6.3% of GDP from 9.1% in 2020. The improved central government fiscal balance narrowed the nonfinancial public sector (NFPS) deficit, which was 5.5% of GDP, two percentage points below the 7.5% deficit ceiling outlined in the country's Social and Fiscal Responsibility Law (SFRL). Buoyed by a rebound in economic activity, the results are credit positive and reflect the government's commitment to complying with the SFRL's gradually narrowing fiscal deficit ceilings.

Our baseline view is that Panama will meet the SFRL deficit target this year (see Exhibit 1). We expect that increased transfers from the Panama Canal Authority (A2 stable) and other revenue-enhancing measures, including changes to the tax agreement with the Minera Panama project, and expenditure restraint, will support deficit reduction this year. However, the central government's increased spending for wages and interest payments increases expenditure rigidity that could complicate compliance with the SFRL's fiscal deficit ceilings (see Exhibit 2).

Exhibit 1

The 2021 NFPS fiscal deficit was narrower than targeted...

NFPS balance, % of GDP

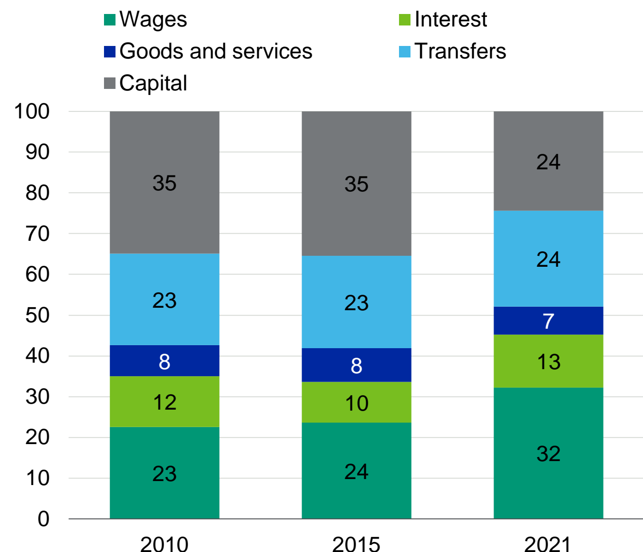


Sources: Ministry of Finance and Moody's Investors Service estimates

Exhibit 2

... but central government current spending is rising

(% of total central government spending)



Sources: Ministry of Finance and Moody's Investors Service

Last year, the central government's current expenditure rose 11.5% from 2020, compared to 5.6% year-on-year growth in NFPS expenditure.[1] A decline in the NFPS' capital expenditure of 17.7% from 2020 indicates that total NFPS spending in 2021 was essentially unchanged from 2020. However, central government fiscal dynamics guide debt accumulation, making the continued rise in current expenditure a risk to future deficit reduction efforts.

Surging revenue supported last year's deficit reduction. NFPS revenue increased 16.9% year-on-year as the economy rebounded from one of the region's deepest recessions. We estimate that real GDP grew 14.5% last year, after contracting 17.9% in 2020. (Panama estimates 15.5% real GDP growth, which is 10.5 percentage points higher than outlined in its 2021 budget.)

The administration's plans to comply with narrowing fiscal deficit targets center on increasing revenue. Without increased taxes and as economic growth moderates to rates closer to 5% in 2022-23, the administration will seek revenue from other sources. The 2022 budget outlines a $2.4 billion contribution from the Panama Canal Authority, $600 million (0.9% of GDP) more than budgeted in 2021. (Canal toll revenue was $2.9 billion in 2021, up 10% from 2020.) Another revenue source is the Minera Panama: Panama negotiated with the mine's operator to increase royalties to 12%-16% of gross profits starting in 2022, targeting a minimum annual fiscal contribution of $375 million (0.5% of GDP).

On the expenditure side, Panama aims to cut subsidies. As economic activity has normalized, the finance ministry targets subsidies returning to 20% of current revenue in 2022, which will help narrow the deficit. Subsidies averaged 41% of current revenue in 2020-21 compared to 20% in 2019 because of pandemic-related support measures.

Assuming the government is able to restrain current spending and achieve revenue-enhancing measures, the reduced deficit should stabilize debt/GDP at around the 64% level achieved in 2021, down from 68.5% in 2020 but up from 46.3% in 2019. After this year, however, the trajectory of Panama's debt metrics will increasingly reflect the government's ability to address challenges from a more rigid spending structure and risks from dependence on Panama Canal Authority transfers.

Endnotes

1 **The NFPS deficit was smaller than that of the central government in part because current and capital transfers between the central government and other public entities are consolidated for the NFPS.**

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Colombia's preliminary 2021 data show accelerated fiscal consolidation and declining debt

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On 4 February, Colombia's (Baa2 stable) Ministry of Finance published preliminary 2021 fiscal data showing a central government deficit[1] of 7.1% of GDP versus 7.8% of GDP in 2020, and a decrease in the debt/GDP ratio to 64% from 65% in 2020. Both metrics outperformed the government's June 2021 medium-term fiscal framework, which projected the deficit at 8.6% of GDP and debt at 67% of GDP.

The credit-positive fiscal consolidation reflects increased government revenue amid Colombia's strong economic recovery. We expect Colombia to continue reducing its deficit this year, and its debt burden to remain broadly stable.

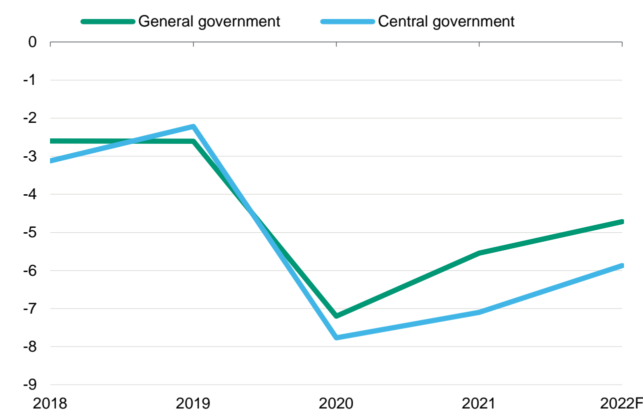
We estimate 2021 real GDP growth at nearly 10% (17% in nominal terms), well above the 5% we forecast at the beginning of last year. Nominal revenue increased 26% versus 2020 (up 12% versus 2019), 7% higher than the government estimated in June 2021 and above what would be expected from nominal GDP growth alone.

The Colombian peso's weakening and an increase in external tax revenue, largely because of import growth of more than 30% last year, contributed to the revenue overperformance. And amid the economy's expansion, government spending was in line with the June 2021 government target (COP275 trillion), making expenditures 1.4% of GDP lower than projected.[2]

Moreover, Colombia achieved these positive fiscal outcomes before full implementation of most of the tax measures included in the September 2021 fiscal reform (*Ley de Inversion Social*). Although the reform includes measures that immediately improved tax compliance and strengthened the institutional framework of the fiscal rule, the bulk of the reform's dividends will come from permanent increases to the corporate income tax rate. These tax measures will be in full effect by 2023 and the administration expects they will raise revenue by about 1% of GDP.

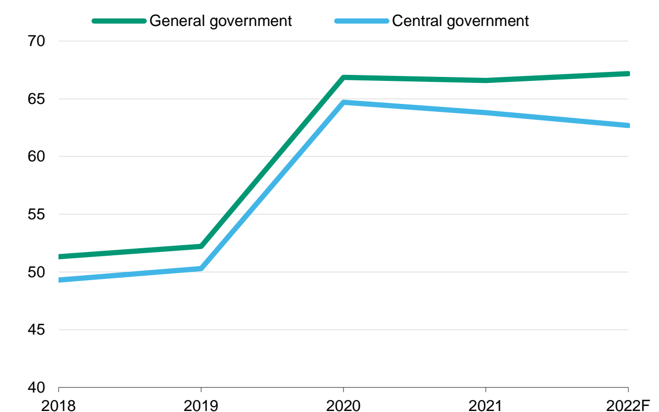
The decrease in the debt/GDP ratio in 2021 is because of lower financing needs and higher growth. Financing needs have also decreased from 14.2% of GDP in 2020 to 11.2% in 2021. We expect fiscal consolidation to continue in 2022 as the economy expands by 4.5% or more in real terms – above its potential of 3.5% – supporting the stability of the government's debt metrics. For 2022, the Ministry of Finance expects the deficit to decrease to 6.2% of GDP and the debt/GDP ratio to fall to 63% (see Exhibits 1 and 2), a level it initially expected only by 2032.

Exhibit 1
Colombia's fiscal consolidation will continue into 2022...
Financial balance as % of GDP



Sources: Ministerio de Hacienda y Crédito Público and Moody's Investors Service

Exhibit 2
...leading to a decreasing debt burden
Gross debt as % of GDP



Sources: Ministerio de Hacienda y Crédito Público and Moody's Investors Service

The government estimates that deficit reduction in 2022 will result in financing needs of 8.6% of GDP, still above pre-pandemic levels[3] but a notable improvement. Most important, lower financing needs this year will allow the government to pursue a financing strategy more reliant on domestic currency debt – shifting to 30% of newly issued debt in foreign currency from approximately 40% in 2021. About half of the foreign-currency debt incurred in 2022 will be from multilateral development banks, which will support debt affordability. This financing mix will help ensure macroeconomic stability in light of the normalization of global financial conditions and an elevated current account deficit.

The 2022 congressional and presidential elections in March and May, respectively, will influence fiscal policy over the next four years. Our baseline scenario incorporates our expectation that the next administration will continue to pursue prudent macroeconomic policies and consolidate government finances pursuant to the recent reform. Beyond the potential election outcome, Colombia's institutions provide a backstop against a material change in policymaking (i.e., relatively prudent fiscal management and central bank independence).

Endnotes

1 Figures throughout this report are at the central government level unless stated otherwise.

2 In June 2021, the government expected that the COP275 trillion in spending would be equivalent to 24.8% of GDP. However, as nominal GDP was higher than expected, spending was equivalent to 23.4% of GDP, relatively unchanged from 23.0% of GDP in 2020.

3 Average financing needs at the general government level between 2015 and 2019 were 6.2% of GDP.

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CREDIT IN DEPTH

FAQ on heightened tensions and an outright conflict between Russia and Ukraine

Originally published on 08 February 2022

Russia's (Baa3 stable) buildup of troops and equipment along Ukraine's (B3 stable) border has increased the risk that tensions may culminate in a further military conflict and – in response – the imposition of new sanctions on Russia. This report answers questions from investors on our baseline expectations and the likely transmission channels and credit implications for both countries of a scenario in which tensions were to escalate.

- **What are Moody's expectations for a military conflict between Russia and Ukraine?** We expect tensions to remain heightened but not escalate further into an outright military conflict given the costs Russia would incur both militarily and economically. However, the risk of a further military conflict has increased, which if it occurred would likely lead us to promptly place both ratings on review for downgrade.
- **What would be the credit implications of new sanctions?** We expect that any military incursion into Ukraine would result in new sanctions being imposed on Russia. Russia has accumulated significant financial buffers that help to insulate its credit profile in the short term from the immediate effects of most new sanctions, though significant new economic and financial restrictions would further weigh on its already low growth potential. The ultimate credit impact of any new sanctions will be determined by the sectors targeted, their scope and the degree of coordination between Western countries.
- **Could sanctions trigger a missed debt repayment and how could that affect the sovereign rating?** While not our baseline, sanctions that disrupt Russia's ability to execute cross-border payments in a timely manner could impede sovereign debt payment irrespective of the amount of liquidity available or Russia's willingness to pay. In such a remote scenario, we would typically classify a missed payment extending beyond the grace period as an event of default. This scenario would typically be consistent with a B1 rating if we assume full recovery for bondholders. We would consider upgrading Russia's rating once any missed payment has been fully cured and we have confidence that a similar event would not occur again. That said, the default event would imply the credit profile is likely inconsistent with an investment-grade rating.
- **What would be the impact of a conflict on Ukraine's credit profile?** Stronger fiscal and external buffers compared to the last military escalation with Russia in 2014-15 would help Ukraine withstand the immediate effects of a conflict. However, we could see material downward credit pressure develop over time unless external financial support was forthcoming given the government's sizeable external debt-repayment needs over the coming years.

Click here for the full report.

Annual US consumer loan growth in Q4 accelerates, a credit negative

Originally published on 09 February 2022

In this pulse of the consumer report, we provide key take-aways from the latest New York Federal Reserve Bank Household Debt and Credit report.

Aggregate household debt rose $333 billion in Q4 to $15.6 trillion, a 7.0% annual increase from 6.2% in Q3, a credit negative because it indicates loosening underwriting standards. Simultaneously, the rate of new delinquencies increased very modestly to 2.03% in Q4 from 1.93% in Q3. New delinquencies were down from 2.66% a year earlier because of solid employment and strong consumer financial health, even as the effect of consumer support measures wanes.

The increase in household debt in Q4 reflected a $258 billion rise in mortgage balances largely because of a strong home purchase market. Credit card balances increased by $52 billion from Q3, the largest quarterly increase on record, and auto loan balances rose by $15 billion. Credit card balances were 4.5% higher than a year earlier but 7.7% lower than in Q4 2019, as consumers took advantage of fiscal stimulus, payment moratoriums and reduced consumption to pay down higher cost debt. We expect credit card loan demand to continue to be solid in coming quarters as the effect of consumer support measures wanes and travel and entertainment spending continues to increase. However, we expect mortgage growth to taper somewhat, as elevated home prices and rising interest rates temper demand for home purchases.

In the years leading up to the coronavirus pandemic, the rate of new consumer loan delinquencies remained around historical lows (the start date for household debt delinquency data is Q1 2003), largely because of the exceptionally strong job market. Delinquencies typically rise following a spike in unemployment, such as that at the onset of the pandemic, because of declining personal income. And as the effect of the pandemic relief measures recedes, we expect the rate of new consumer loan delinquencies to continue to rise and begin to reach 2019 levels in the first half of 2023 (Exhibit 1).

Exhibit 1

Rate of new delinquencies ticked up in Q4 from Q3; we expect performance to deteriorate moderately later this year and begin to reach 2019 levels in the first half of 2023

Year-over-year loan growth rates and rate of new delinquencies

	Loan Growth Rate			Rate of New Delinquencies		
	Q4 2021 growth rate	Q4 2020 growth rate	Three-year annualized growth rate	Current quarter	One-year ago (Q4 2020)	One-year projected trend
Total household debt	7.0%	2.9%	4.8%	2.03%	2.66%	Increase moderately
Credit cards	4.5%	-11.7%	-0.5%	4.10%	5.12%	Increase moderately
Auto loans	6.1%	3.2%	4.6%	4.96%	5.45%	Increase moderately
Residential mortgages	8.8%	5.1%	6.2%	1.57%	1.98%	Increase moderately

Sources: Federal Reserve Bank of New York and Moody's Investors Service

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Editors

Jay Sherman, Elisa Herr, Andrew Bullard, Julian Halliburton and Phil Macdonald

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