Credit Outlook

17 February 2022

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FIRST READS

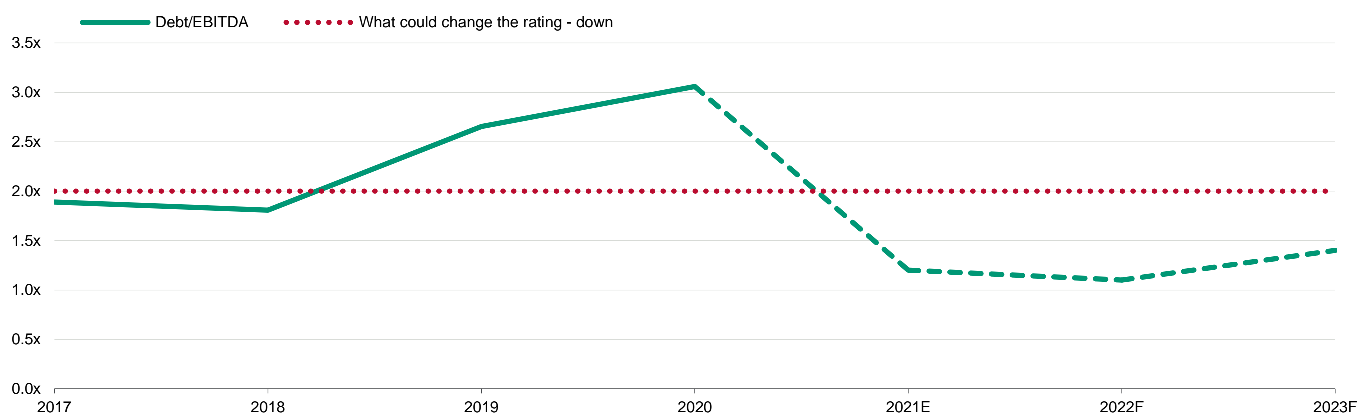
Potential end to investigations of Glencore is credit positive, despite cost

Originally published on 16 February 2022

On 15 February, Glencore (Baa1 stable) announced strong 2021 results and said that it expects several key investigations into the company's past conduct to be resolved this year at an estimated cost of $1.5 billion. Despite the cost, clarity around the investigations' resolution timing and financial effect is credit positive after several years of uncertainty, and the company can accommodate the estimated cost without materially weakening its credit profile.

Glencore has been subject to a number of investigations by regulatory and enforcement authorities. These started in July 2018 with a subpoena from the US Department of Justice (DOJ), and include investigations by the US Commodity Futures Trading Commission, the UK Serious Fraud Office and the Brazilian Federal Prosecutor's Office. Investigations will remain pending in Switzerland and the Netherlands, but resolving key investigations would substantially remove a key governance concern at a manageable cost given around $5 billion of free cash flow after dividends in 2021 and liquidity in excess of $10 billion at year end. The exhibit shows Glencore's currently strong financial position, which, under our assumptions for metal prices, is likely to continue this year.

Glencore has a strong financial profile on the back of record results in 2021



The 2021E is a Moody's estimate based on unaudited accounts. The 2022F and 2023F are our forecasts. All numbers are on a Moody's-adjusted basis
Source: Moody's Investors Service

Although the financial implications are clearer, whether any non-financial requirements form part of any investigation's conclusion and the actual findings of the investigations remain uncertain. However, Glencore has already made a series of changes since the investigations began, including changes to its management and board, strengthening its governance and compliance procedures in its marketing operations. Enhanced procedures now include, for example, more limited and strictly controlled use of third-party agents, more robust know-your-customer checks on an ongoing basis, and employee training, which should reduce the risk of future governance issues.

Glencore continues to optimise its portfolio and also disclosed that it has an agreement to sell its stake in Russneft PJSC (Caa2 negative). The sale is a step in simplifying and optimising its portfolio operationally and from a governance perspective. Optimising its portfolio on assets with steady performance also allows management to increase its focus on core operations. However, the company is also still active in a number of higher risk regions and as a result some governance risks remain.

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.

For 2021, Glencore reported record company-adjusted EBITDA of $21.3 billion (+84% against 2020) and company-defined funds from operations of $17.1 billion (+105%). Company-adjusted net debt stood at $6 billion down from $15.8 billion in 2020.

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Uber's strong EBITDA growth will drive rapid deleveraging, a credit positive

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On 10 February, Uber Technologies, Inc. (B2 stable) said it expects strong and profitable growth for the next three years, with gross bookings (GB) growing at a compounded annual growth rate of 22%-25%, which with margin improvements will lead to adjusted EBITDA of about $5 billion in 2024. Uber's EBITDA growth will drive rapid deleveraging after years of sizeable cash burn. We expect Uber to generate slightly negative free cash flow in 2022, and more than $1.6 billion of free cash flow in 2023, which will reduce reliance on debt to fund organic investments.

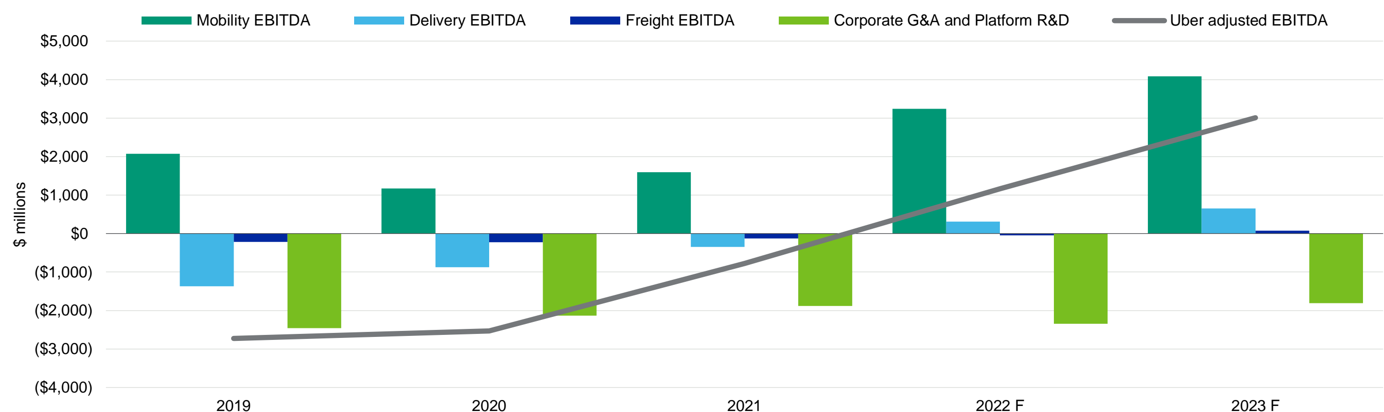
Uber plans to maintain high growth rates by leveraging its platform and substantial scale to increase consumer engagement, driver earnings and consumer spending on its platform. In the Mobility segment, Uber is focused on increasing penetration of existing ridesharing services and expanding use cases of ridesharing, such as shared rides, scheduled rides, Uber for Business, taxis, and peer-to-peer services in certain markets.In the Delivery segment, Uber expects to maintain high growth rates by expanding delivery beyond food to groceries, convenience, and retail. The company expects advertising revenue across its online platforms to grow to more than $1 billion in 2024, from $11 million in 2020. Similar to other e-commerce platforms, we expect the digital advertising business will have very high EBITDA margins. Uber's Freight segment has a large growth opportunity by disrupting a highly fragmented freight brokerage services market through its technology platform that has real-time visibility into demand and supply and has over 1 million drivers.

While elements of the company's growth strategy will need to be proven amid competitive and regulatory challenges, we believe that Uber's turnaround in profitability in the second half of 2021 and management's ability and commitment to expand EBITDA margins while continuing to invest in the growth will lead to a sustainable increase in free cash flow. We expect Uber's adjusted EBITDA (non-GAAP basis and as reported by the company) to grow to $1.2 billion in 2022 and $3 billion in 2023, driven by a rebound in ridesharing volumes and improving EBITDA margins in all segments (Exhibit 1).

Exhibit 1

We expect a rebound in ridesharing volume and rising profitability across all segments will drive rapid EBITDA growth

Adjusted EBITDA for total company and segments, and shared corporate expenses



Adjusted EBITDA is as reported by the company. Shared corporate expenses include corporate G&A and platform R&D expenses as reported by the company

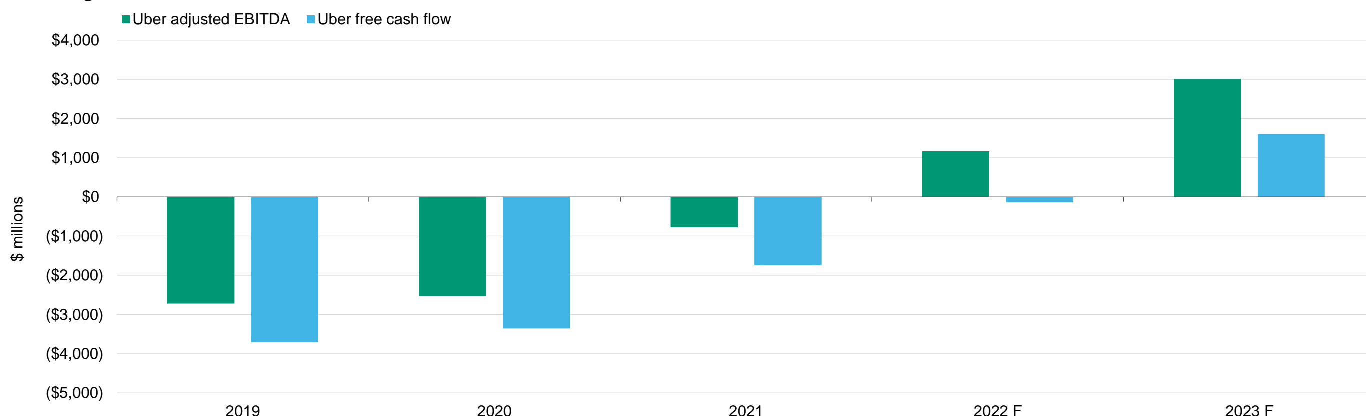
Sources: Company filings and Moody's Investors Service estimates

The company's cost structure improved after it implemented nearly $1 billion in cost reduction following the pandemic. The effects of the Omicron virus have been less severe on the Mobility segment compared to prior waves of COVID-19 variants. If risks to public health from the Omicron variant continue to subside, we expect Mobility segment's adjusted EBITDA to nearly double in 2022 from 2021. The company has made significant progress in increasing the supply of drivers, which has been a key challenge for Uber as

demand for rides started recovering, especially during 2021. In fourth-quarter 2021, management reported that excluding investments on increasing driver supply, EBITDA margins on incremental gross bookings were already at the long-term target of 10%. In 4Q21, Uber's Delivery segment turned adjusted EBITDA positive. The company expects to improve EBITDA margins in the Delivery segment through rationalization of incentive spending on new drivers and customers, increase in batch orders and route densities, and by leveraging fixed costs as volume grows (Exhibit 2).

Exhibit 2

EBITDA growth will translate into more than $1.6 billion in free cash flow after 2022



Adjusted EBITDA on a non-GAAP basis and as reported by the company
[F] Moody's forecast
Sources: Company filings and Moody's Investors Service estimates

We expect Uber to generate $1.6 billion in free cash flow 2023 with potential upside. This would be a marked improvement from about $1.7 billion of negative free cash flow in 2021 (excluding the one-time benefit of $1 billion related to the transfer of auto insurance arrangements from a third-party). Uber's credit profile is strongly supported by its very good liquidity with $4.3 billion of cash and $12.6 billion of minority investments in other transportation businesses. Its declining need for debt to finance growth initiatives and its rapidly improving profitability will further strengthen its credit profile.

At the same time, high regulatory and litigation risks and strong competition across its services will continue to represent key challenges. The resolution and timing of Uber's pending lawsuits and settlement proceedings are uncertain but the company had recorded approximately $2.6 billion of aggregate liabilities related to various legal and regulatory matters and non-income tax disputes. Uber's license to operate in the city of London is due for renewal by the local transportation regulator in May 2022. The competitive environment in both ridesharing and food delivery businesses has been stable since the outbreak of the pandemic. But competition for market share in ridesharing could escalate as demand improves and industry profitability continues to strengthen. In the food delivery business, competition for diners and restaurants will likely become more aggressive as demand patterns return to normal and order frequencies and basket sizes potentially decline. Uber has divested many non-core assets and at the same time it has been aggressive in acquiring businesses. Any increase in debt related to acquisitions could offset anticipated improvements in credit metrics.

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Saudi Aramco's share transfer to Public Investment Fund is credit positive

Originally published on 15 February 2022

On 13 February, Saudi Arabian Oil Company (Saudi Aramco) announced that the Kingdom of Saudi Arabia (A1 stable) had transferred 4% of its ownership in the company to Public Investment Fund (PIF, A1 stable), the kingdom's sovereign wealth fund. The share transfer is credit positive for PIF because it increases its assets under management, improves its sector diversification and adds an asset that regularly pays dividends to its portfolio. The transfer reflects the fund's importance to Saudi Arabia and its key role in implementing the country's Vision 2030.

The transaction required no payments to Saudi Arabia from PIF and is therefore akin to an equity injection. PIF's assets under management will increase by SAR296.4 billion ($79 billion) or 20% versus year-end 2020 following the transfer, based on Saudi Aramco's market capitalisation as of 13 February. The transaction will also improve PIF's already strong sector diversification. The share transfer increases PIF's exposure to the oil and gas sector, though this exposure will decrease as it continues to redeem its holdings of Saudi Aramco promissory notes.

The transfer will also increase dividends that PIF receives, which in turn will improve its interest coverage ratio (as measured by [funds from operations + interest expense]/interest expense at the PIF level). Saudi Aramco is a regular dividend payer and has had a strong commitment to pay at least $75 billion in annual dividends, which will result in additional dividend income of SAR11.25 billion ($3 billion) per year.

The transfer reflects Saudi Arabia's commitment to PIF. Since a change in oversight in 2015 to the Council of Economic and Development Affairs from the Ministry of Finance, the fund has received regular asset transfers from Saudi Arabia, and we expect additional contributions in the future.

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China Hongqiao's strong earnings growth is credit positive

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On 11 February, leading aluminum producer China Hongqiao Group Limited (Ba3 stable) announced that its net profit was likely to be more than 60% higher in 2021 than in 2020. The strong earnings growth is credit positive and mainly reflects rising aluminum prices in China (A1 stable), which support the company's solid profitability and will lead to strong cash flow generation and an increase in its financial flexibility.

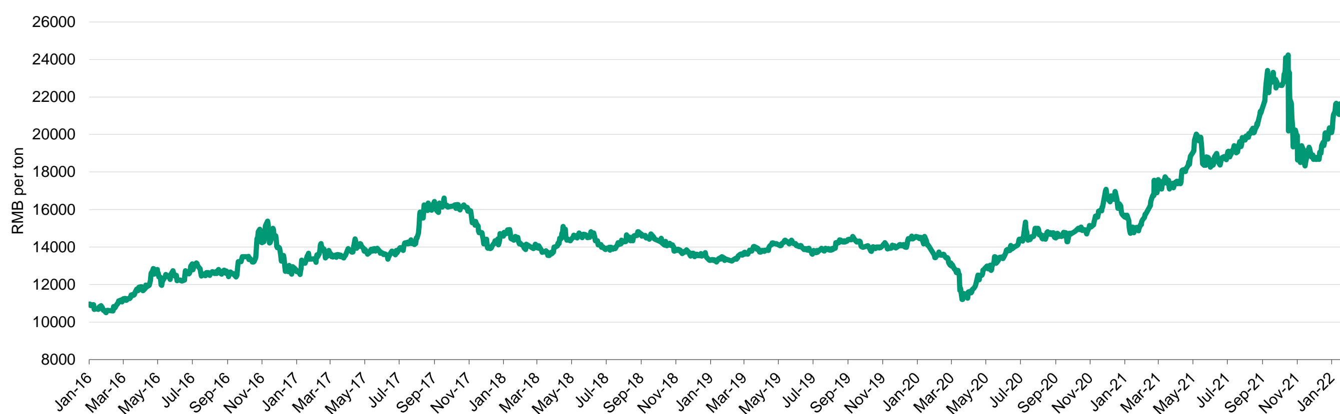
In 2021, aluminum prices reached their highest level in 15 years, according to the China Nonferrous Metals Industry Association, while strong product prices mitigated increasing electricity costs driven by surging coal prices. The company successfully passed on inflation costs to customers.

We expect aluminum supply to remain tight because of regulatory controls on production capacity, while infrastructure demand could offset weakness in the property market. As a result, there could be a sustained period of high aluminium prices.

China Hongqiao lowered its leverage – as measured by total adjusted debt/EBITDA – to 2.1x as of 30 June 2021 from 3.8x in 2018, using its strong cash flow. Total debt declined to RMB68.7 billion as of 30 June 2021 from RMB75.5 billion at the end of 2020. We expect the company to continue to reduce its debt and maintain leverage below 2.5x in 2022.

Aluminum prices in China have risen to around RMB23,000/ton in February 2022 (see exhibit) compared with less than RMB12,000/ton in March 2020. We expect aluminum price strength to last through the first half of 2022, supported by stable demand and limited new supply. High aluminum prices and favorable market conditions will support China Hongqiao's cash flow generation and increase its financial capacity for deleveraging.

The Shanghai Changjiang aluminum spot price has remained high



Sources: Wind Information Services and Moody's Investors Service

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Fed's 2022 stress test has more pronounced economic decline, a credit positive for US banks

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On 10 February, the US Federal Reserve Board (Fed) published the scenarios for its 2022 stress test under the Dodd-Frank Act Stress Test (DFAST). Many of the economic indicators under this year's severely adverse scenario deteriorate more than in the 2021 stress test, an intentional part of the design, which calls for a more pronounced economic decline when conditions are stronger. The 2022 severely adverse scenario includes a sharper increase in market volatility, a greater decline in residential real estate values, and a larger increase in the unemployment rate.

Assessing US banks' capital adequacy under these assumptions is credit positive because it supports the maintenance of capital buffers, requiring banks to demonstrate capital strength and resiliency even though the current economic outlook is more favorable than the stress scenario.

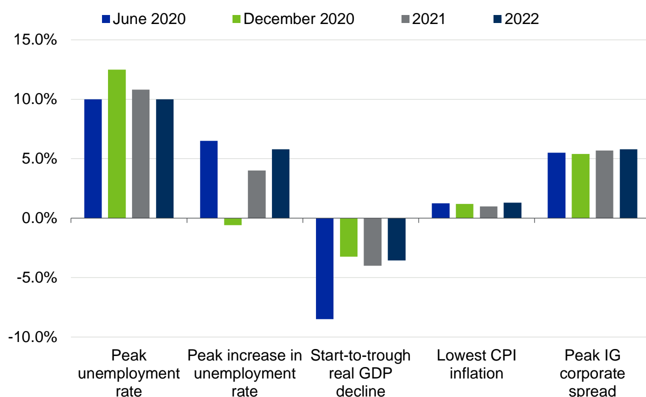
This year's stress test will include 34 participants compared with 23 in 2021. The larger number includes the Category IV firms that are on a two-year supervisory stress test cycle. The DFAST is a forward-looking assessment of the capital adequacy of bank holding companies that allows the Fed to ensure that US banks can continue to lend during times of stress with no adverse effect on the real economy. DFAST is also used to calculate each bank's stress capital buffer requirement. Following completion of DFAST, each bank's stress capital buffer requirement for the next four quarters is set equal to the larger of either 2.5% or the maximum decline in the bank's Common Equity Tier 1 (CET1) capital ratio over the DFAST projection horizon plus four quarters of common dividends. The Fed also evaluates the capital adequacy and planning processes of the largest US bank holding companies, and of the large US operations of foreign banks, based on their planned capital distributions, including dividends and share buybacks. The Fed will publish the results of the 2022 stress tests by the end of the second quarter. It will then publish the capital requirements that are determined by the test by the end of the third quarter.

Under the DFAST, the Fed applies two scenarios: baseline and severely adverse. The baseline scenario is based on average projections from a survey of economic forecasters, and the severely adverse scenario features stress assumptions to assess the ability of banks to withstand unfavorable economic conditions. Each scenario includes 28 variables representative of domestic and international economic activity.

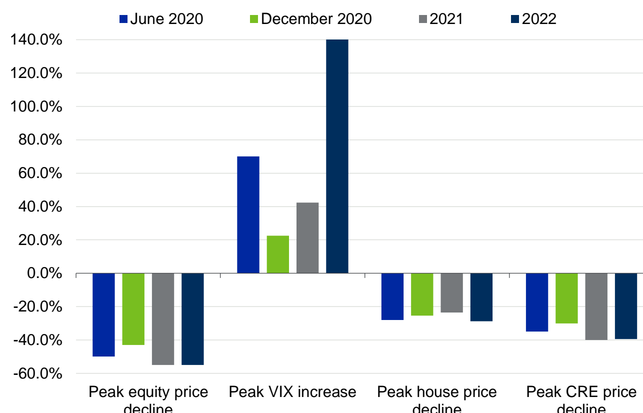
This year's severely adverse scenario is characterized by a severe global recession, similar to previous tests, with heightened stress in commercial real estate (CRE) and corporate debt markets and high equity market volatility (Exhibits 1 and 2). Under the scenario, prolonged continuation of remote work leads to a large CRE price decline of almost 40%, similar to the 2021 assumption. This spills over to the corporate sector and affects investor sentiment. The corporate bond spread widens to 5.75% in mid 2022, which is modestly higher than last year. The adverse scenario also reflects greater stress in emerging market economies, partly driven by building risks in the Chinese economy. As a result, market volatility is higher, with a substantial increase in the Chicago Board Options Exchange's Volatility Index, the VIX, compared with last year.

Many of the changes in variables are modestly more severe than in the 2021 scenario, though the absolute level may not be as unfavorable. This is the result of current conditions, which are better than at the same time last year, and the Fed's Scenario Design Framework. For example, as shown in the charts below, the peak unemployment rate of 10% is lower than in the 2021 test, but the 5.75% increase in the unemployment rate to the peak is larger. Like last year, the severity of assumptions suggests that the value of trading assets banks hold will decline and that the largest stress will fall on those banks whose trading activities are less effectively hedged and that have large CRE loans outstanding.

Key assumptions under the Fed's severely adverse scenario



Source: Federal Reserve



Source: Federal Reserve

Other points of comparison between the 2022 assumptions and 2021 assumptions under the severely adverse scenario include:

» The start-to-trough decline in US real gross domestic product (GDP) is 3.5%, which is lower than the 4% drop in the 2021 scenario. Although the largest single quarterly decline is higher than last year the 2022 scenario incorporates only five quarters of negative real GDP growth versus seven quarters in the 2021 test.

» CPI inflation falls from an annual rate of 8.25% at the end of 2021 to an annual rate of about 1.25% in Q3 2022 and then gradually increases to above 1.5% by the end of the 13-quarter scenario.

» The assumed decline in equity prices is 55%, unchanged from 2021.

» The decline in house prices is 29%, higher than 24% in 2021.

» Short-term interest rates remain near zero through the stress test horizon, while long-term rates drop in the first quarter and do not increase until Q4 2022 and then continue to gradually rise to 1.5% in Q1 2024. This path represents a larger decline in long-term rates than last year. With short-term rates near zero, even with a modest yield curve steepening, this will constrain bank's net interest income.

In addition to these scenarios, 12 firms are required to incorporate into their stress tests the sudden default of their largest loss-generating counterparty, and 10 of these firms that have significant trading operations are also required to include a global market shock. The 2022 global market shock is characterized by a sharp curtailment in global economic activity, a tightening of financial conditions represented as a sharp rise in benchmark lending rates, and a worsening of existing supply-chain disruptions. An increase in term risk premiums drives an increase in Treasury rates and a steepening of the yield curve. Compared with the 2021 shock, the key differences are the behavior of interest rates and commodities prices. The yield curve is steeper and interest rate volatility shocks are larger. Commodity prices appreciate in this year's scenario, whereas last year they declined. Key differences between the global market and the macroeconomic scenarios include the timing of recognition of profits and losses from trading and counterparty credit, which are marked to market in the first quarter of the projection horizon. The Fed has indicated that applying the global market shock in the first quarter ensures that potential losses from trading and counterparty exposures are incorporated into trading companies' capital ratios at all points over the projection horizon.

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Mali's missed payments are credit negative for regional banks

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On 11 February, the Union Monetaire Ouest Africaine-Titres (UMOA-Titres) announced that the Government of Mali (Caa2 review for downgrade) missed a CFA27.5 billion ($48 million) payment on a commercial bond. Since late January, the government has failed to make CFA53 billion ($91.6 million) of interest and principal payments on Malian treasury bonds.

The government's missed payments are credit negative for banks in Mali and in the West African Economic and Monetary Union (WAEMU), which includes Benin, Burkina Faso, Cote d'Ivoire, Guinea Bissau, Mali, Niger, Senegal and Togo. The WAEMU members share a common currency, the franc de la Communauté financière de l'Afrique (CFA). The Malian banking system had total assets of CFA5.9 trillion ($10.4 billion) as of October 2021, or 11.2% of the WAEMU region's CFA52.7 trillion ($92.8 billion) of total assets.

The missed payments increase the risk of losses on regional banks' holdings of Malian sovereign bonds, which could diminish their profitability and increase provisioning requirements if the situation persists for several months. We estimate that holdings of Malian sovereign bonds are low for Togo based-banks, and are negligible for most Moroccan banks operating in Mali.

Rated Togo-based banks with operations in Mali include Ecobank Transnational Incorporated (B3 stable, b2[1]) and Oragroup S.A. (Caa1 negative, caa1); and residential mortgage refinancing vehicle CRRH-UEMOA (Ba2/Ba3 stable, b1[2]). CRRH-UEMOA mitigates its exposure to Mali's banking system with conservative loan structuring that materially reduces the credit risk through the mutual support of the client banks and a substitution rule in their mortgage portfolios. CRRH-UEMOA client banks have a statutory and contractual obligation to provide a cash advance to CRRH-UEMOA in lieu of the cash owed by a defaulted bank. Additionally, the pledged collateral, a residential mortgage portfolio with first liens on the underlying properties, has a substitution rule that obligates borrowing banks to replace any delinquent mortgage loan with a performing mortgage loan of similar face value.

Other banks operating in Mali include Morocco-based Attijariwafa bank (Ba1 negative, ba3), Groupe Banque Centrale Populaire (Ba1 negative, b1), and Bank of Africa – BMCE Group (Ba1 negative, b1) and Nigeria-based United Bank for Africa Plc (B2 stable, b2).

The 11 February missed payment follows economic and financial sanctions by the Economic Community of West African States (ECOWAS) and the WAEMU in early January 2022 after Mali's military-led government proposed extending its military rule to five years, rather than sticking to its previous commitments to hold elections by February this year. ECOWAS in January blocked all Malian government payments from passing through the Central Bank of West African States (BCEAO) payment system.

Besides possible crystallisation of losses on government bonds, the sanctions on cross-border payments pose risk to the liquidity of Mali's banking system, which so far has been broadly stable. According to our information, Malian and regional banks have so far retained the ability to refinance themselves at the BCEAO using WAEMU sovereign bonds as collateral -- including Malian government bonds. Corporate and retail cash deposits and withdrawals at Malian banks are also broadly stable.

If the current situation persists for several months, it poses significant risk to the liquidity of Malian banks. If ECOWAS sanctions were to be strictly implemented for several months, they would increase the risk of materially hampering the liquidity and functioning of Mali's banking system. In such a situation, support from the BCEAO and other regional authorities to the regional banking systems would be an important factor to help maintain liquidity and preventing contagion.

Endnotes

1 The bank ratings shown in the report are the banks' deposit rating and Baseline Credit Assessment.

2 The ratings shown for CRRH-UEMOA are its long-term Corporate Family Rating, its foreign currency long-term issuer rating and standalone assessment

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SEC's transparency push for private fund market is credit positive for investors and advisers

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On 9 February, the Securities and Exchange Commission (SEC) proposed new investor reporting requirements for private fund advisers that manage hedge funds, private equity funds and private credit funds. The rules, which are open for public comment, would require the advisers to provide investors more detailed reporting on fees, expenses and fund performance. The new rule would stop private fund advisers from engaging in activities with potential conflicts of interest could harm fund investors or the financial system at large.

Increased transparency is credit positive for private fund advisers because it should increase investor confidence in private funds, which is likely to translate into even higher growth rates for assets under management (AUM). However, greater disclosures will allow investors to compare fund performance and fees more easily, which is likely to put downward pressure on private fund advisers' fees. Large private fund managers such as Blackstone Inc. and KKR & Co Inc. will easily comply with the SEC's reporting requirements because their own investor disclosure practices are already consistent with the SEC's proposals, but compliance for smaller private fund managers will be more of a financial burden.

The private fund market has grown significantly since 2015, fueled in part by investors' need for yield in a historically low interest rate environment. The AUM of private funds managed by SEC-registered investment advisers was $17 trillion as of 30 September 2021, up 55% from $11 trillion as of year-end 2016; the AUM of private funds managed by exempt reporting advisers' AUM grew 150% to $5 trillion as of 30 September 2021 from $2 trillion as of year-end 2016.

Because of their growing influence in the US economy, the SEC under Chairperson Gary Gensler is making stronger oversight of private fund advisers a top priority, even though sophisticated institutional investors have driven the market's growth, rather than the retail investors the SEC has historically focused on protecting.

The SEC's proposal follows its 22 January vote to amend confidential reporting Form PF for certain SEC-registered investment advisers to private funds. The SEC substantially shortened the allowable time frame for private fund advisers to inform the SEC of events within their funds that could affect fund investors or the broader financial system – requiring them to report such events within one business day. In its most recent announcement, the SEC referenced state and municipal public pension funds' large investment allocations to private funds as a key reason to bring more transparency to an otherwise opaque industry.

Private fund advisers would need to comply with SEC's new disclosure proposals

The proposed new rules would:
Require private fund advisers registered with the SEC to provide investors with quarterly statements detailing information about private fund performance, fees and expenses;
Require registered private fund advisers to obtain an annual audit for each private fund and cause the private fund's auditor to notify the SEC upon certain events;
Require registered private fund advisers, in connection with an adviser-led secondary transaction, to distribute to investors a fairness opinion and a written summary of certain material business relationships between the adviser and the opinion provider;
Prohibit all private fund advisers, including those not registered, from engaging in certain activities and practices that are contrary to the public interest and the protection of investors; and
Prohibit all private fund advisers from providing certain type of preferential treatment that have a material negative effect on other investors, while also prohibiting all other types of preferential treatment unless disclosed to current and prospective

Source: Securities and Exchange Commission

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Brookfield's potential spin-off of a share of its asset-light business could be credit negative

On 10 February, Brookfield Asset Management, Inc. (Baa1 stable) introduced the concept of separating a minority share of its asset management business. In its fourth-quarter 2021 letter to shareholders, Brookfield questioned whether a part of its asset-light fee-earning asset management business might be separated into a new entity, leaving the asset-heavy invested-capital business, plus a controlling stake of the asset-light fee-earning asset management business, on the existing company's balance sheet.

For now, Brookfield's idea of splitting off a part of its business is conceptual, and it has not addressed or formulated many details, at least in public. Potentially equalizing steps could be taken that would reduce the dilution to creditors of Brookfield, such as paying down debt. But, depending on the details, such a separation would seem to be credit negative for Brookfield's debtholders. Any diversion of distributable earnings (which were $7.0 billion in 2021 before corporate activities and preferred dividends) that is contributed by fee-related earnings (FRE) (which were $1.9 billion in 2021, and $2.6 billion including net carried interest) would leave existing investors relatively more reliant on dividend distributions from its listed partnerships and potentially volatile gains from asset dispositions.

The rationale for undertaking such a separation is rooted in unlocking value – or realizing the conglomerate discount that Brookfield believes weighs on the value of its combined businesses. From an equity perspective, if public valuation of the company's stock is less than the combined intrinsic values of its component businesses, it may make sense to make these businesses into separate traded entities, providing optionality to those who want an asset-light security . However, depending on how such a split occurs, and whether value is diverted away from the entity supporting debt claims, it may be unfavorable to creditors.

As Brookfield explained in its letter, if most of its $50 billion of own-parent company investment capital were distributed to shareholders, the company could quickly and easily become asset-light. Under such a construct, we calculate that its FRE plus net carried interest might achieve a market valuation of 20x, a 25% increase using a recent trading multiple of Blackstone's asset management earnings for comparison. We estimate that the current stand-alone valuation of Brookfield's asset management business is approximately 16.5x (see Exhibit 1).

Exhibit 1

Brookfield's standalone asset management earnings are valued at a discount to Blackstone's

Brookfield's share of capitalization from net invested capital is relatively high

	Brookfield	Blackstone
Share price (2/11/2022)	$58.05	$123.57
[x] Shares (millions)[1]	1,652	1,203
Capitalization	**$95,875**	**$148,705**
[-] Net invested capital[2]	52,777	21,018
Asset Manager valuation	**43,098**	**127,687**
[÷] FRE+net realized carried interest (millions)	2,614	6,376
Asset manager multiple (x)	**16.5**	**20.0**

[1]Blackstone Distributable Earnings shares outstanding

[2]Cash and company-owned investments, less debt

Sources: Company reports and Moody's Investors Service

Based on remarks during the company's earnings conference call, Brookfield would retain the majority of the asset managers' earnings and the company's existing balance sheet and remaining asset management earnings would continue to support debt. However, the portion spun off into a separate listed company would reduce that share. The company allowed as to how it might separate and distribute to its shareholders up to a quarter or a third of the business.

Using the maximum of the stated range, we estimate that removing one-third of fee-related earnings from 2020 and 2021 results would have increased the multiple of distributable earnings (before corporate activities and preferred share dividends) by 0.3x-0.4x. Since net realized carried interest and dispositions are more variable contributors to distributable earnings, it is useful to consider the multiple before adding back those elements. The debt and preferred capital multiple would increase by 0.6x-0.7x on a pro forma basis (see Exhibit 2).

Exhibit 2

Allocations of earnings to NewCo would increase Brookfield's multiples

Pro forma analysis of debt and preferred capital multiples, assuming 33% allocation to NewCo

USD millions	Reported values		Adjustment	Pro forma values	
FOR THE PERIODS ENDED DEC. 31	**2021**	**2020**	**Up to one-third to NewCo**	**2021**	**2020**
Fee-related earnings	**1,899**	**1,428**	**x 66.7% =>**	**1,266**	**952**
Distributions from investments	**2,198**	**1,846**		**2,198**	**1,846**
Add back: equity-based compensation costs	119	94		119	94
Distributable earnings[1] before realizations	**4,216**	**3,368**		**3,583**	**2,892**
Debt & preferred capital multiple	*3.6*	*4.0*		*4.3*	*4.7*
Increase of multiple				*0.6*	*0.7*
Realized carried interest, net	**715**	**348**	**x 66.7% =>**	**477**	**232**
Disposition gains from principal investments	2,100	1,185		2,100	1,185
Distributable earnings[1]	**7,031**	**4,995**		**6,160**	**4,309**
Debt & preferred capital multiple	*2.2*	*2.7*		*2.5*	*3.1*
Increase of multiple				*0.3*	*0.4*
BAM net invested capital					
Invested capital	68,027	58,278		68,027	58,278
Corporate borrowings	(10,875)	(9,077)		(10,875)	(9,077)
Perpetual preferred shares	(4,375)	(4,375)		(4,375)	(4,375)
Invested capital, net	**52,777**	**44,826**		**52,777**	**44,826**

[1]Distributable earnings are shown before corporate activities (interest expense, costs and taxes) and preferred share dividends

Sources: Company reports and Moody's Investors Service

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Kenyan central bank's CBDC report highlights benefits for financial inclusion and cross-border transactions

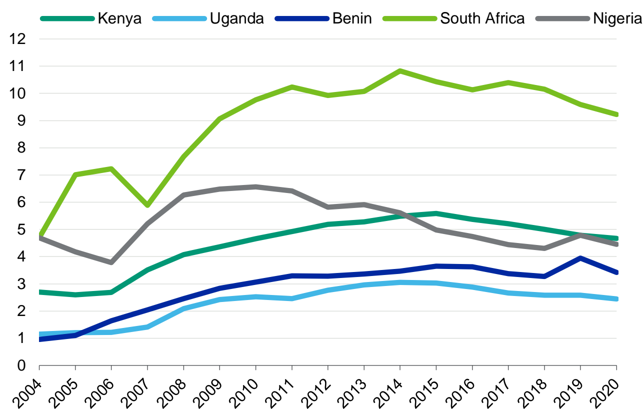
Originally published on 16 February 2022

On 11 February, the Central Bank of Kenya (B2 negative) published a discussion paper requesting public comment on the possible use of a central bank digital currency (CBDC) and its potential benefits and risks. A Kenyan CBDC would help increase financial inclusion and could reduce the cost of cross-border transactions such as remittances, while also supporting growth. However, its overall credit effect would depend on its technical design and use as a means for facilitating financial inclusion .

Kenya has already made substantial progress on financial inclusion over the past decade. According to the World Bank, 82% of people over the age of 15 had an account at a bank or other type of financial institution as of 2017, up from 42% in 2011. However, a CBDC could reduce financial access disparities across different demographics, such as the lowest-income groups and rural residents, for whom access to bank branches can be difficult. A central bank survey in 2021 showed higher levels of financial exclusion among these two demographic groups compared with the highest-income groups and urban residents.

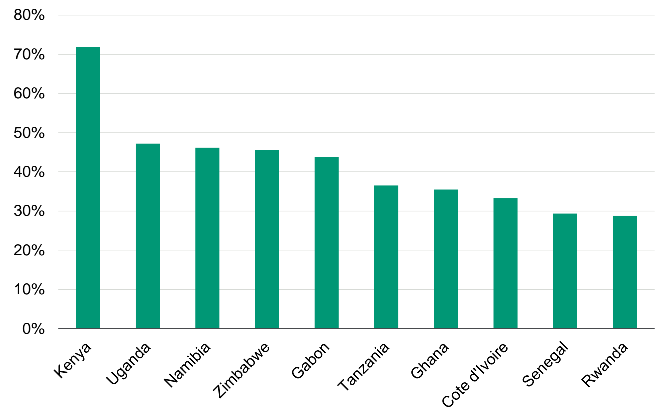
Access to banking institutions in Kenya remains low relative to more developed peers such as South Africa (Ba2 negative) (see Exhibit 1). However, strong usage of mobile money payments, such as M-Pesa, indicates a high degree of comfort with digital payment methods (see Exhibit 2).

Exhibit 1
Physical access to traditional financial institutions has fallen since 2015...
Commercial bank branches per 100,000 adults



Sources: World Bank and Moody's Investors Service

Exhibit 2
...while mobile phone and internet use is the highest in the region
Percentage of individuals in 2017 using a mobile phone or the internet to access a financial account



Sources: World Bank and Moody's Investors Service

A CBDC could reduce the cost of cross-border transactions and increase the convenience of receiving remittances, which totaled $3.7 billion in 2021 (3.4% of GDP). The Sustainable Development Goals sets a target for the cost of remittances of less than 3% by 2030. According to a central bank survey published in December last year, the average cost of sending money via money transfer companies and mobile money operators averaged 4%-5% in 2019.

The central bank's discussion paper identified a number of CBDC risks, including technology risks posed by a CBDC's infrastructure, money laundering risks and financial disintermediation of banks, which would constrain credit growth. The Eastern Caribbean Central Bank recently reported a technical outage on its pilot CBDC, DCash, that prevented users from completing transactions.

Disruption to Kenyan banks, payment providers and other financial institutions from a CBDC will depend on a number of key design and policy choices. A two-tier retail CBDC model, under which financial intermediaries maintain their client-facing roles and play a

part in disseminating CBDCs, is a more likely and cautious approach, but could still be highly disruptive. Other policy choices include potential holding limits, whether CBDCs bear interest, cost of use compared with existing alternatives and accessibility.

Banks and payment system providers face heightened disintermediation, funding and fee loss risks as CBDCs are adopted, even under some of the more benign scenarios. Although CBDCs in many cases do not pay interest and are not intended to compete directly with bank deposits, a CBDC would provide an attractive risk-free alternative to bank deposits, raising funding costs by constraining access to deposit funding and in turn reducing banks' ability to provide credit to the economy, potentially raising the cost of credit. A CBDC would also enable the broad use of risk-free instant payments through a potentially cheaper central bank-operated payment infrastructure. This would reduce the share of payment processing, which are currently mainly performed by mobile payment providers such as M-Pesa and to a lesser degree banks and other financial institutions, eating into their fee income and reducing their profitability.

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Higher refinancing rate increases borrowing costs for Russian regions, a credit negative

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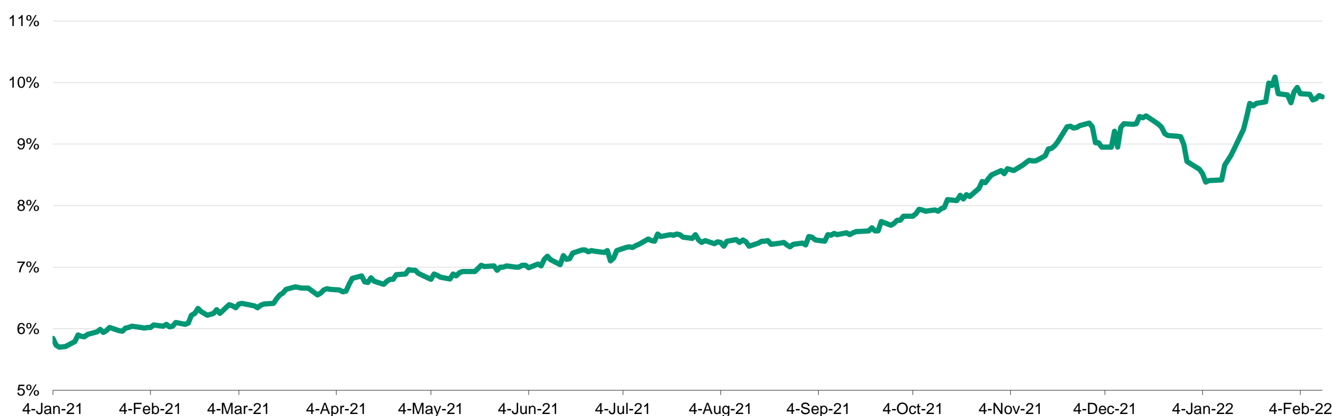
On 14 February, the Central Bank of Russia increased its key repo refinancing rate by 100 basis points to 9.5% to tighten financial sector liquidity, defending the ruble and reducing inflationary pressure from the pandemic and geopolitical tensions over Ukraine. The move, which follows a 425-basis-point rise over the past year, is credit negative for Russia's regions because it will increase the cost of new borrowing and pressure weaker regions with new debt needs in particular.

The increased rate means Russian regions will have to pay higher interest on bank loans and issue debt securities with higher coupons, and high inflation will support elevated rates. We estimate the new cost of funding for Russian regions at around 9%-11%, up from 4%-6% a year ago (Exhibit 1). As a result, the regions will have to assume up to an additional RUB7 billion of annual interest expenses on the debt they refinance this year. Should these elevated rates persist, repricing all the regions' market debt at the new rates is likely to translate into additional annual interest costs of up to RUB55 billion.

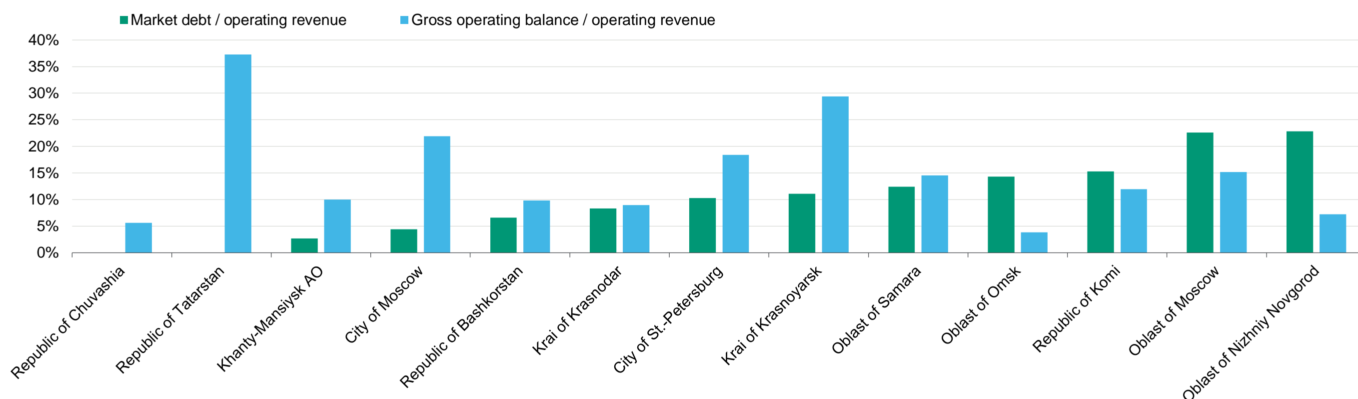
Exhibit 1
Yield-to-maturity index of Russian regional government bonds



Source: Moscow Stock Exchange

Higher borrowing costs will have the greatest effect on regions with substantial market debt. Among the regions we rate, these are Oblast of Nizhniy Novgorod (Ba2 stable), Oblast of Omsk (Ba3 stable), Oblast of Moscow (Ba1 stable) and Republic of Komi (Ba3 stable). However, an adequate operating performance will mitigate pressure on their budgets. Regions with low market debt and strong budgetary performance, namely Republic of Tatarstan (Ba1 stable), City of Moscow (Baa3 stable), Khanty Mansiysk AO (Ba1 stable) and Republic of Chuvashia (Ba2 stable), will be less affected (Exhibit 2).

Exhibit 2
Market debt burden and operating performance of Russian regions



Sources: Russian Federal Treasury, Russian Ministry of Finance and Moody's Investors Service

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Energy ties raise risks, but credit effect from limited Russia-Ukraine conflict is low

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The presence of Russian (Baa3 stable) troops and equipment along Ukraine's (B3 stable) border induces the risk that tensions may culminate in military conflict[1], which would likely trigger sanctions from Western governments and retaliatory action from Russia, including potential disruption to energy supplies. Given Europe's[2] reliance on Russian hydrocarbon imports, energy supply is likely to be the dominant channel through which the regions' sovereigns would be impacted by such a scenario, though some are also vulnerable to trade disruption and security risks, especially cyberattacks. Countries in the Baltics and Central and Eastern Europe (CEE) are most exposed via all three of these channels, but such risks are to a greater extent already accounted for in our assessment of political risk for the Baltics[3]. Our baseline view is that Russia-Ukraine tensions will stop short of an outright military conflict, and the risk of material credit pressures emerging is low unless such a conflict were to carry on for an extended period or escalate into outright conflict beyond Ukraine.

Exhibit 1

The Baltics and CEE are most exposed to an escalation of tensions with Russia

Exposure: VERY LOW LOW MODERATE HIGH VERY HIGH

COUNTRY	ENERGY	TRADE	SECURITY
Latvia (A3 stable)	HIGH	MODERATE	MODERATE
Lithuania (A2 stable)	HIGH	MODERATE	MODERATE
Estonia (A1 stable)	VERY LOW	MODERATE	MODERATE
Poland (A2 stable)	MODERATE	VERY LOW	MODERATE
Slovakia (A2 stable)	VERY HIGH	LOW	LOW
Hungary (Baa2 stable)	VERY HIGH	VERY LOW	LOW
Czech Republic (Aa3 stable)	HIGH	LOW	LOW
Romania (Baa3 stable)	MODERATE	VERY LOW	LOW
Bulgaria (Baa1 stable)	MODERATE	LOW	LOW
Sweden (Aaa stable)	VERY LOW	VERY LOW	LOW
Finland (Aa1 stable)	VERY LOW	MODERATE	LOW
Germany (Aaa stable)	HIGH	VERY LOW	LOW
Austria (Aa1 stable)	HIGH	VERY LOW	VERY LOW
Italy (Baa3 stable)	HIGH	VERY LOW	VERY LOW
Greece (Ba3 stable)	HIGH	VERY LOW	VERY LOW

Energy scores are based on the share of Russian gas in a country's energy supply and electricity generation, our assessment of economic resilience and adjustments for large gas supplies or ready access to LNG terminals. Trade scores are based on the share of exports to Russia relative to total exports and GDP. Security scores are based on our qualitative assessment of geopolitical event risk.
Source: Moody's Investors Service

Click here for the full report.

Endnotes

1 See FAQ on heightened tensions and an outright conflict between Russia & Ukraine, 8 February 2022

2 For the sake of this analysis, we have excluded the other 12 members of the EU-27 where we deem exposure to be limited for all three of the energy, security and trade channels.

3 Political risk, including geopolitical risk, is one of the four components of our assessment of a sovereign's susceptibility to event risk, one of the four factors of our assessment of a sovereign's creditworthiness

Rapid growth of challengers puts new verve into old banking systems

Originally published on 15 February 2022

The accelerated shift to digital brought about by the pandemic has been a boon for the digital challenger banks that have proliferated across the globe over the last decade. Most expanded their customer base and broadened their products. A few that were knocked back by the economic turmoil have since rebounded. While they face some key challenges ahead, we expect they will continue to gain in scale, through innovative, low-cost offerings, steadily building market share and widening their product base.

Our report focuses on the largest 20 challenger banks across the world, based on customer numbers, total assets, enterprise valuation, or, if listed, market capitalization. We define challenger banks as financial technology firms (fintechs) that hold a banking license.

Superior technologies, underbanked populations, rising digitalization, supportive regulation and investor backing have driven dramatic growth. The aggregate assets of the 20 largest challenger banks tripled to $319 billion between 2017 and 2020, according to our estimates, while their aggregate customer base jumped to 610 million from 167 million.

Around half are profitable and some outperform. The speciality of the challenger banks is leveraging technology to dramatically lower costs and improve the client experience. They offer similar products to incumbents, but their streamlined operations and tech focus cut time and costs and allow personalization of products at scale. Eleven of the 20 challengers in the scope of this report were profitable in 2020, while WeBank, XW Bank, Rakuten Bank, Tinkoff and OakNorth outperformed their domestic sectors in terms of return on equity.

Still minnows in terms of assets and revenue, they have surged ahead in customer numbers and growth rates. Incumbents still dwarf the challengers in terms of asset size, loan portfolio, revenue and net income. The largest challenger in our sample is Rakuten Bank with assets of $58.7 billion at the end of 2020. This is just 1.7% of the assets of JPMorgan Chase & Co. But challengers outperform on client acquisition and asset growth.

The challengers face obstacles ahead but we expect them to continue to gain in scale. Challenger banks struggle to achieve primary bank account status, particularly in developed countries. Monetary tightening may also mean that venture capital becomes less abundant in the months to come, while shortcomings in compliance may result in regulatory fines and slower customer growth. Their low-cost online model and multimillion customer base, however, offer strong potential for cross-selling and further revenue growth. We expect challengers will continue to build market share in the years ahead through continued expansion and a broadening product mix.

Click here for the full report.

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- BAT's share buybacks will constrain leverage reduction and investments in new products
- Growth in potentially reduced-risk products continues unabated, a credit positive for Philip Morris
- Valeo acquires Siemens' 50% stake in Valeo-Siemens eAutomotive joint venture, a credit negative
- Siemens' fiscal first-quarter results show strong operational performance, a credit positive

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- Hamburg Commercial Bank's stronger profitability reflects progress on transformation process, a credit positive

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Editors

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

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