CreditOutlook

Credit Implications of Current Events

30 APRIL 2015

NEWS & ANALYSIS

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Corporates

Comcast's Failed Bid for Time Warner Cable Is Credit Negative for Both

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Last Friday, Comcast Corporation (A3 positive) announced that it would walk away from its approximately $45 billion planned acquisition of Time Warner Cable, Inc. (Baa2 negative) as a result of regulatory pressure. The merger's collapse is credit negative for both companies, denying Comcast a chance to claim the lucrative New York and Los Angeles markets and making Time Warner Cable a target for a more highly leveraged buyout. Following last Friday's developments, we changed Time Warner Cable's rating outlook to negative from review for upgrade.

The significant regulatory pushback that the all-stock deal received also raises questions about whether Comcast will be allowed to make any further acquisitions of cable systems, a wireless company, or content, in the future.

In our view, securing the two largest US cable markets (New York and Los Angeles) and expanding its footprint by about one third would have benefitted Comcast in the commercial telecommunications and broadband business. An East Coast footprint from Washington through New England, one of the most heavily trafficked corridors in the US, would have allowed Comcast to compete more effectively as it moves up-market to service larger businesses. It currently serves small to midsize businesses with lower-cost, more-scalable solutions that produced year-over-year revenue growth exceeding 20%.

A larger consumer footprint also would have helped offset increases in network and broadcast-station affiliate and retransmission fees (the fees cable operators pay to carry channels), the primary reason for margin pressure and rising pay-TV rates for consumers. We expected that Comcast's proprietary X-1 set-top box innovations and added services would have been favorably received by subscribers in its new markets, resulting in lower video subscriber losses than the company has experienced recently. We have a positive outlook for Comcast's rating, and had planned to consider whether the larger scale warranted an upgrade to A2/Prime-1 without necessarily achieving and sustaining stronger credit metrics.

As for Time Warner Cable, there is a high likelihood that the company could be the target of another buyout. In particular, we're on the lookout for a renewed bid from Charter Communications Inc. (Ba3 stable) via a highly leveraged deal using Time Warner Cable's otherwise strong balance sheet. In that situation, Time Warner Cable's credit metrics would suffer and it could result in a multi-notch downgrade of its credit ratings. There is a slim possibility that another suitor such as Cox Communications, Inc. (Baa2 stable) makes a more financially conservative offer or a jointly structured arrangement with Charter. But, in our view, weaker credit metrics are likely to be the result in most scenarios.

Charter must also contend with some credit-negative effects from Comcast pulling its bid for Time Warner Cable. Charter was to acquire approximately 2.9 million Time Warner Cable subscribers and approximately 33% of a new publicly traded cable provider (GreatLand) serving approximately 2.5 million customers that was to be spun off from Comcast. The purchase would have materially increased Charter's scale while holding ground on credit metrics.

Separately, Charter's proposed acquisition of Bright House Networks (unrated) – which we also considered credit positive because of the significant equity component of the purchase price and the further increase in scale – was contingent on the Comcast transactions and will not occur without a renegotiation.

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Piaggio's Competition in India for Three-Wheel Vehicles Increases, a Credit Negative

Last Friday, India-based two-wheeler and three-wheeler manufacturer Bajaj Auto (unrated) announced that it will reenter the three-wheeler commercial vehicle market in 2016. The increased competition will be credit negative for Italy-based Piaggio & C. SpA (Ba3 negative), the current market leader in the segment in India, because it will pressure Piaggio's growth prospects in Asia.

Bajaj exited the three-wheeler cargo market in 2013 to focus on three-wheeler passenger carriers, a segment in which it was the largest producer in India with a 49% market share in the 12 months to 30 June 2014, followed by Piaggio, with a 30% share.[1]

Piaggio has a solid market position in India, especially in the three-wheel commercial vehicle segment, where it had a strong 52% market share in the 12 months to 30 June 2014. India is by far the largest single market for Piaggio by sales (25%) and, according to the company's business plan, is the key driver for recovery in the Asian market.

Although its market share has been fairly stable over the past several years, Piaggio's market leadership has been challenged since 2012 by Mahindra & Mahindra's growing market share. The second-largest manufacturer in the cargo segment, Mahindra & Mahindra had a 23% market share in the 12 months to 30 June 2014, up from 15% in the 12 months to 30 June 2010.

With the re-entry of Bajaj next year and its aggressive goal of gaining a 20% market share in its first year, Piaggio's market dominance is under threat, especially since competition in the cargo segment, where permits are not required, is even stiffer than in the three-wheel passenger segment. Assuming that Bajaj achieves this target – which we think will be challenging – and assuming that half of that market share will come from Piaggio, we estimate that Piaggio's global sales would decline by roughly 5%, which, in turn, would slow the company's deleveraging.

Despite Piaggio's established position in the commercial segment, a more competitive landscape increases uncertainty about the magnitude of its recovery prospects in India, especially after a volatile 2014, when sales grew by 4% over 2013 but were quite erratic from quarter to quarter and foreign exchange rates had a negative effect.

For 2015, we forecast volume growth of 6%-7% for Indian commercial vehicles, supported by our expectation of increased need for goods transportation amid improving macroeconomic conditions and infrastructure development, and revenue growth in the mid- to high-teen percentages, supported by a weaker euro.

[1] All market share statistics in this article are from international consulting firm Roland Berger.

Infrastructure

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NGPL Buys Time to Restructure, a Credit Positive

On Tuesday, NGPL PipeCo. LLC (Caa2 negative) released its year-end 2014 financial statements and announced a second amendment to its credit facility ($598 million term loan and $75 million revolver). The amendment incorporated covenant waivers including the requirement that the annual financials be issued without a "going concern" qualification for the 2014 financial audit, the interest coverage compliance test for fourth-quarter 2014, first-quarter 2015 and second-quarter 2015, and the leverage ratio compliance test for the same three quarters.

Waiving the covenants is credit positive for NGPL because it buys NGPL's owners-sponsors (Myria Acquisition LLC (unrated), which owns 80%, and Kinder Morgan Inc. (Baa3 stable), which owns 20%) time to either restructure the balance sheet or to sell the assets outright. The breathing room is likely to benefit creditors because NGPL's transmission and storage assets, which serve roughly 60% of the Chicago, Illinois, market, have strong fundamental value and are attractive acquisition targets for master limited partnerships, yieldcos or infrastructure-oriented private-equity owners.

NGPL has an untenable capital structure and steadily eroding liquidity profile. Even with the relief from having to meet its current 1.20x EBITDA interest coverage and 9.75x debt/EBITDA leverage covenants, we see few indicators to help the company overcome insufficient liquidity over the next eight months. NGPL's financial profile remains weak because of declining gross profit and low natural gas prices.

The amendment to the credit agreement does waive certain default triggers that could be prompted imminently and provides relief from interest coverage and leverage covenant tests for the next two compliance periods, and affords NGPL the opportunity to use $50 million of cash, currently held at NGPL Holdco LLC (unrated), for interest and principal payments in June and December. However, even with full use of its $75 million revolver (which was fully drawn as of Tuesday) and $50 million of equity injections, NGPL is unlikely to have sufficient cash flow to cover the approaching cash interest payments of more than $90 million and mandatory term loan payments of $25 million.

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EDP - Energias do Brasil's Divestiture of EDP Renováveis Is Credit Positive

On Monday, EDP - Energias do Brasil S.A. (EDB, Ba1 review for downgrade) announced that it had agreed to sell its 45% stake in EDP Renováveis Brasil S.A.(unrated) to Spain-based EDP Renováveis S.A. (unrated) for as much as BRL190 million. The divestiture would be credit positive for EDB because it would help the company meet its short-term cash needs this year amid an acquisition, a need to inject capital into some of its power projects and smaller upstreamed dividends from subsidiaries.

Based in Sao Paulo, Brazil, EDB is a holding company controlled by EDP - Energias de Portugal, S.A. (Baa3 stable) with activities in generation, distribution and commercialization of electricity. In 2014, EDB's power distribution business constituted 55% of its consolidated EBITDA, while the power generation business accounted for 39% and the commercialization of energy constituted the remaining 6%.

EDB will receive BRL176 million at the transaction's close, which the company expects in the second half of 2015, plus up to BRL14 million in earn-out payments. The deal is subject to the approval of Brazil's Conselho Administrativo de Defesa Econômica (CADE), or Council of Economic Defense.

The proceeds will come as EDB prepares to spend BRL300 million to acquire a 50% interest in Eneva's (unrated) thermal power project PECEM I, which recently filed for bankruptcy protection in Brazil. In addition, we expect EDB to inject BRL200-BRL300 million of capital into some of its power projects this year as part of capital expenditures to expand and maintain these projects. The sale proceeds will also help to offset the company's expectation of lower upstreamed dividends from EDB's subsidiaries owing to a currently challenging business environment in the Brazilian electricity sector brought on by a severe drought since 2013.

The up to BRL190 million of proceeds will complement a BRL750 million bridge loan that the company plans to take out using local debentures as soon as investor interest in local capital markets improve.

Banks

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Deutsche Bank Must Execute Consistently to Achieve Planned Credit Benefits

On Sunday, Deutsche Bank AG (A3 stable/A3 review for downgrade, baa3[2]) announced a long-expected strategic recalibration in conjunction with its first-quarter 2015 results. The plan sets ambitious goals for higher capitalization, lower leverage and more conservative return-on-equity targets that, if fully achieved, would be positive for bondholders. However, many of the eventual benefits to creditors are largely offset by the plan's considerable execution risk, as management continues to strengthen profitability and rebalance the bank's earnings mix over the next three to five years.

The announcement is part of a developing credit story at Deutsche Bank, and holds no immediate rating implications. The key changes to Deutsche Bank's strategic objectives and their credit effect are summarized in Exhibit 1. The plan is to be completed by 2020. However, management has not provided or committed to specific completion dates for the individual initiatives.

EXHIBIT 1

Deutsche Bank's Key Strategic Initiatives and Their Effect

Parameter	Old Target	New Target	Credit Effect
Common Equity Tier 1 Capital	Greater than 10%	Approximately 11%	Positive
Leverage	3.5%	Greater than or Equal to 5%	Positive
Cost Savings	€4.5 Billion through 2015	Additional €3.5 Billion	Positive
Cost to Achieve	€4.0 Billion through 2015	Additional €3.7 Billion	Negative
Cost/Income*	Approximately 65% by 2016	Approximately 65%	Negative
Post-Tax Return on Equity (ROE) and Return on Tangible Equity (ROTE)	Approximately 12% ROE by 2016	Greater than 10% ROTE	Positive
Payout Ratio	Unspecified	50%	Neutral
Ownership of Postbank	Retain	Dispose	Neutral

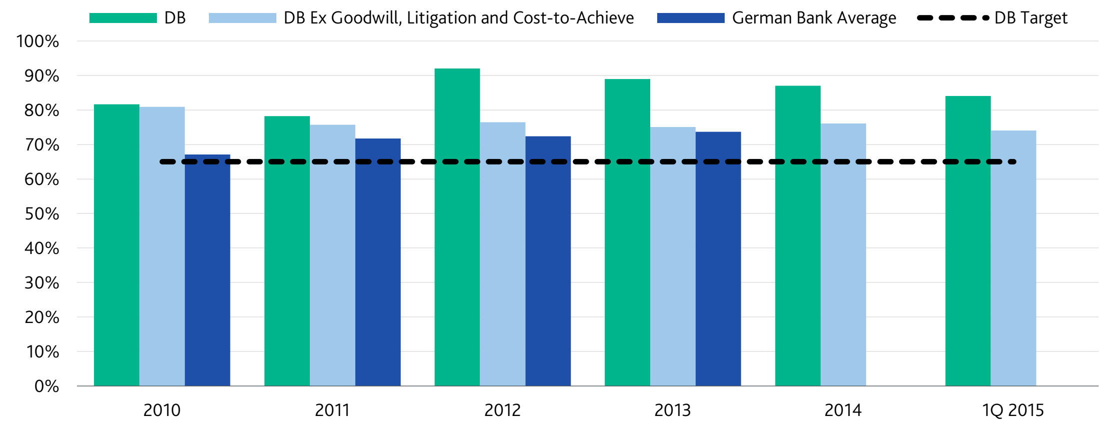
*The ratio of non-interest, non-credit expenses to net revenues.
Source: Deutsche Bank

Deutsche Bank stayed committed to a universal banking model, despite plans to deconsolidate Deutsche Postbank AG. Management intends to invest €2.5 billion into wealth management, retail banking and transaction banking, while enhancing digital capabilities, shuttering branches and shrinking its foreign footprint. Strengthening and stabilizing earnings in these businesses would be credit positive, creating a better balanced business mix that helps protect bondholders against the volatility of capital markets businesses through the cycle.

Despite the eventual benefits of this model, the bank will have difficulty consistently generating the capital to fund investments, creating considerable execution risk over the next two years. Achieving the elusive 65% cost/income goal will be difficult given the continuing drag of the legacy portfolio, as well as episodic litigation and regulatory costs (see Exhibit 2).

[2] The ratings shown are Deutsche Bank's deposit rating, senior unsecured debt rating and baseline credit assessment.

EXHIBIT 2
Deutsche Bank's 65% Cost/Income Goal Is Elusive



Note: Adjusted cost-income for first-quarter 2015 (light blue bar) excludes litigation and cost to achieve and is normalized assuming a 38% full-year compensation accrual as opposed to 33% actually accrued in the quarter.
Sources: Deutsche Bank reported results and Moody's Banking Financial Metrics

Deutsche Bank is three quarters of the way through its original plan to cut €4.5 billion out of the 2012 cost base, and it is unclear how it would generate an additional €3.5 billion in savings without cutting into muscle, controls or both. Furthermore, revenue attrition associated with the planned balance sheet reductions within Corporate Banking and Securities may be greater than management's estimates of €600 million of run-rate revenue losses.

We see the eventual divestment and deconsolidation of Postbank as credit neutral. Postbank contributed €880 million (or roughly one third of the core retail division earnings over 2013-14). However, Postbank's liabilities also contributed €824 million in non-core unit losses during this time and these liabilities would remain with Postbank. We do not view the loss of Postbank's deposits as negative, since they were ring-fenced and not available to fund other Deutsche Bank units.

Although Sunday's announcements overshadowed its first-quarter results, Deutsche Bank's first-quarter performance indicates the potential, and pitfalls, of its proposed business model. The first quarter is typically Deutsche Bank's strongest revenue quarter owing to seasonal factors for banks with extensive capital market operations. The firm reported €1.5 billion in pretax earnings from €10.4 billion in revenue for an annualized return on risk-weighted assets (RORWA) of 137 basis points.

The bank's quarterly results suffered from €1.5 billion of costs related to the settlement of LIBOR litigation, and benefitted from an unusually low compensation accrual of 33%. Despite the substantial LIBOR settlement, the firm increased its contingent liabilities for reasonably possible litigation reserves by €1.3 billion to €3.2 billion. Excluding the litigation costs, and assuming a more normalized full-year compensation accrual rate of 38%, pretax profits would have totaled €2.4 billion and RORWA would have been 223 basis points.

Overall, Deutsche Bank's strategic course correction is a logical recalibration of the previous plan and continues management's pursuit of better and more balanced profitability. Nonetheless, it is clear that the reengineering of Deutsche Bank's business model still has years to run before its credit-positive effects will be entrenched.

Insurers

Ontario's Reduction in Accident Benefits Is Credit Positive for Canadian Insurers

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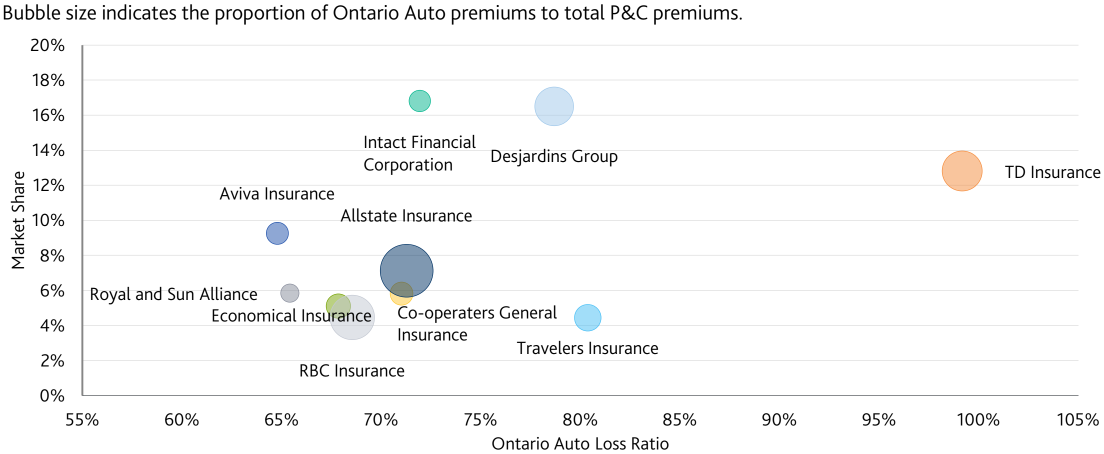
On 23 April, as part of its 2015 budget, the Canadian province of Ontario announced measures to lower both consumer and industry costs related to accident benefits of standard automobile insurance policies in the province. These changes are part of a wider government initiative to lower Ontario automobile insurance pricing through mandated rate reductions, while maintaining insurer margins by redesigning regulations to reduce industry costs. This announcement is credit positive for Canadian property and casualty (P&C) insurance companies that write Ontario auto insurance because it will reduce profit margin pressure from continuing rate reductions.

The government announced several key changes to minimum mandatory coverage. Policy limits for medical, rehabilitation and attendant care benefits will fall to CAD65,000 from CAD86,000. The definition of catastrophe impairment will be updated with more recent medical information and the related benefits will be reduced by half to CAD1 million. In addition, the standard duration of medical and rehabilitation benefits will fall to five years from 10 for all claimants except children. These measures will contain the severity of claims costs to insurers.

The 10 largest Ontario auto insurers had a combined market share of 88%, based on direct premiums written in 2014, and most participants are diversified across multiple insurance lines. Although Intact Insurance Company (financial strength A1 stable) is the largest P&C insurer in Canada based on total direct written premiums, both Intact and Desjardins Group's (unrated) insurance operation have roughly equivalent market shares in Ontario's auto insurance at about 17%. Exhibit 1 illustrates the relative size, profitability and market share of Ontario's top 10 auto writers.

EXHIBIT 1
Ontario's Top 10 Auto Writers in 2014
Bubble size indicates the proportion of Ontario Auto premiums to total P&C premiums.

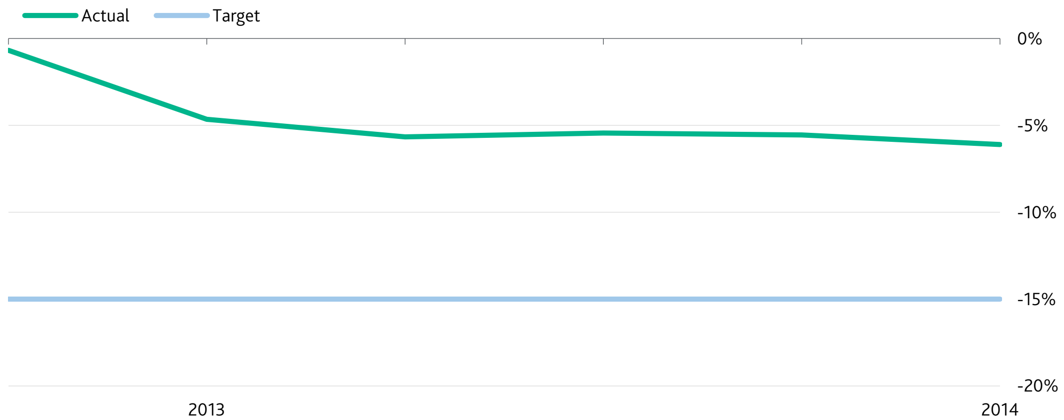


Note: Desjardins data includes all premiums of State Farm Insurance.
Sources: MSA Research Online and Moody's Investors Service

Like other Canadian provinces with private auto insurance plans, Ontario's government regulates consumer rate-setting and auto insurers operating in the province must file premium rate applications with the provincial regulator, the Financial Services Commission of Ontario (FSCO). As part of the Auto Insurance Cost and Rate Reduction Strategy announced in 2013, the government stated that it would reduce auto insurance rates by 15% on average within two years. The 23 April announcement reported an average industry reduction of 7%, less than half of the original amount (Exhibit 2).

EXHIBIT 2

Ontario Auto Industry Rate Changes



Sources: Financial Services Commission of Ontario and Moody's Investors Service

This is the second set of changes announced by the Ontario government to reduce costs. In December 2014, the province enacted legislation to reduce costs associated with dispute resolution, towing and storage fees and professional medical fees. The full effect of these changes will be known in the coming year.

According to the Insurance Bureau of Canada, auto insurance premiums in Ontario were 27% higher than in Alberta in 2014 and almost twice as high as those in the Atlantic provinces (British Columbia, Saskatchewan, Manitoba and Quebec have public plans). The higher premium differential is largely attributed to more generous accident benefits, which has led to higher claims costs and elevated levels of fraud.

Sovereigns

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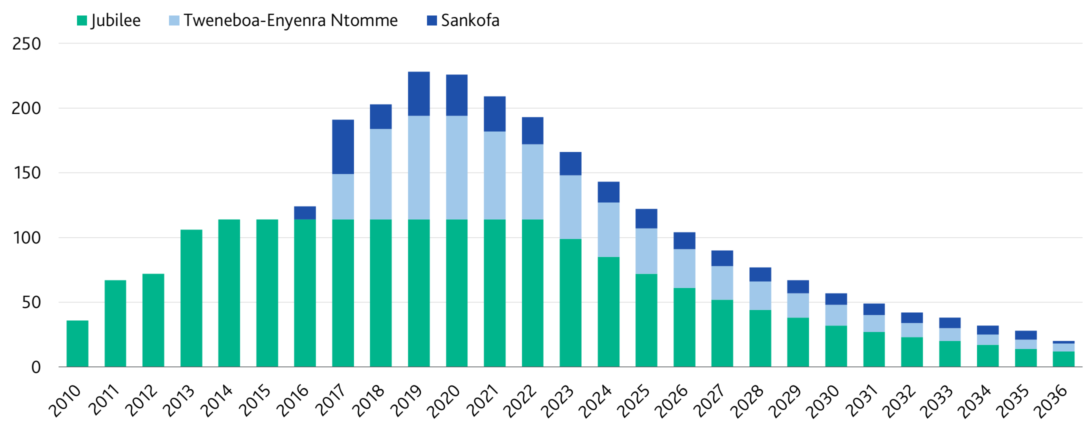
Ruling on Ghana's Maritime Border Dispute with Cote d'Ivoire Is Credit Positive for Ghana

Last Saturday, the International Tribunal for the Law of the Sea ruled that Ghana (B3 negative) can continue production at the Tweneboa-Enyenra Ntomme (TEN) oil field, but must not start new exploration until Ghana's maritime border dispute with Cote d'Ivoire (B1 positive) is resolved, an outcome most likely to come in late 2017. The tribunal's decision to allow the TEN project to continue is credit positive for Ghana because it removes a threat to Ghana's growth and revenue projections over the next two years.

Operated by a consortium led by Tullow Oil plc (B1 negative), the TEN oil field is Ghana's second-largest oil field. It is more than 55% complete and is scheduled to start production in mid-2016 with capacity to reach 80,000 barrels per day. Ghana's first oil field, the Jubilee, currently produces 100,000 barrels per day, with capacity of up to 120,000, and is not involved in the border dispute. Based on our forecast of an average oil price of $72 per barrel during 2016-19, we expect the government's annual oil receipts from the TEN field to total 1.0-1.5 percentage points of GDP.

Together with the Sankofa offshore gas project, which is also not involved in the border dispute and is scheduled to commence production in 2017, we expect increased oil and gas production to ease downward pressure on Ghana's foreign exchange buffers and support growth prospects over the next five to seven years in our base-case scenario (see Exhibits 1 and 2). Had the tribunal fulfilled Cote d'Ivoire's request to immediately cease all activity in the disputed region until the resolution of the border dispute, it would have prevented TEN from reaching its production targets. That risk was a factor, albeit a less significant one, in the negative outlook we assigned when we downgraded Ghana to B3 from B2 on 19 March.

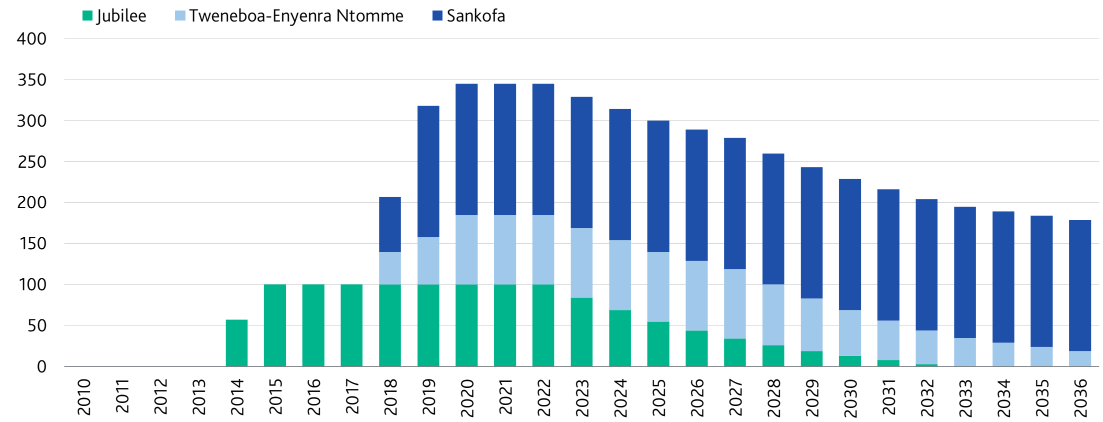
EXHIBIT 1
Ghana's Oil Production by Thousand Barrels per Day



Source: World Bank

EXHIBIT 2

Ghana's Gas Production by Million Cubic Feet per Day



Source: World Bank

In terms of exploration, the tribunal's decision to suspend new drilling in the disputed waters does not affect our oil and gas production base case because it only includes the development of the TEN field in the disputed area. However, it limits any potential upside that may have come from any oil discoveries over the next few years.

Moreover, until the tribunal rules on Cote d'Ivoire's claim, uncertainty over Ghana's oil production and government revenues will persist. The tribunal's order to suspend new drilling speaks to the tribunal's judgment that Cote d'Ivoire's claims on the area are at least plausible. An ultimate ruling in favor of granting partial or full ownership of the disputed area to Cote d'Ivoire would likely require the division of past and future revenues from the field between the two governments. Potentially significant compensation payment claims on Ghana in the event of an adverse ruling risks jeopardizing part or all of the government's receipts from the TEN oil field.

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NEWS & ANALYSIS

RATINGS & RESEARCH

Last week, we downgraded Advanced Micro Devices, Banca Monte dei Paschi di Siena, MPS Capital Services, Eurasian Bank, Belarusbank, Belagroprombank, BPS-Sberbank, Belinvestbank, Minsk Transit Bank, Kaspi Bank, BBK, National Bank of Bahrain and Bahrain Development Bank. We upgraded Celgene, Service Corporation International, The Hartford Financial Services Group, Chaco Province in Argentina, four classes of Banc of America Commercial Pass-Through Certificates Series 2006-1 and one subordinate class of TCF Auto Receivables Owner Trust 2014-1, among other rating actions.

Last week, we published on China's anti-corruption campaign, South and Southeast Asian high-yield corporates, global advertising, Mexican construction and infrastructure, global private debt issuance, media sector covenants, Central Eastern European corporates, US packaged foods, Asia telecommunications, global aerospace and defense, North American building materials, Brazil's banks, Saudi Arabian insurance, Brazil and Petrobas, Africa Finance Corp., Caribbean sovereigns, Asia Pacific sovereigns, ASEAN economic integration, Suriname, Cayman Islands, Fiji, Bahrain, Islamic Corporation for the Development of the Private Sector, Czech and Polish local governments, US muni debt service reserve funds, global RMBS, European covered bonds, Portuguese covered bonds, Japanese securities with currency swaps, US CMBS, Sequoia jumbo RMBS, utility true-ups, Green Tree settlement and European SME-loan-backed securitizations, among other publications.

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