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**INC’s Merger with inVentiv Is Credit Negative for INC and Positive for inVentiv**

Last Wednesday, contract research organizations (CROs) INC Research Holdings Inc. (Ba2 review for downgrade) and inVentiv Group Holdings Inc. (B3 review for upgrade) said they will combine in an all-stock merger valued at about $4.6 billion. The deal is credit positive for inVentiv because it will become part of a company with meaningfully lower financial leverage, significantly larger scale and a more diverse business mix. Although INC will also benefit from increased scale and business diversity, it will become part of a company with significantly higher financial leverage, which is credit negative.

Following the merger announcement, we placed inVentiv’s ratings on review for upgrade and INC’s ratings on review for downgrade. We estimate that the combined company will have pro forma adjusted leverage of around 5.0x debt/EBITDA, excluding synergies, compared with current leverage of 7.0x for inVentiv and 2.2x for INC.

The merger, which the companies expect to close in the third quarter of 2017, will create a company with $3 billion in revenues and a leading market position in pharmaceuticals contract research and commercialization services. It will be among the top five CROs, with combined CRO net service revenue of $2.1 billion, compared to $1 billion for each company on a standalone basis. CROs help pharmaceutical companies design and execute testing and clinical trials of new drug candidates. Building scale is important to CROs because it can help them better withstand contract cancellations and project delays, which are inherent to the business.

The combination offers strategic benefits for both companies, which have complementary customer bases with little overlap. INC, which focuses on late-stage clinical trials, serves mostly small to mid-size pharmaceutical companies. inVentiv, by contrast, has a larger presence among big pharmaceutical companies, and in addition to CRO services, offers communications and commercialization services. inVentiv offers a more flexible CRO model than INC, which allows it to serve larger pharma companies that want to outsource some, but not all, parts of their clinical development. INC’s lack of scale in this flexible delivery model caused it to win less new business than it expected in 2016.

The transaction is each companies’ largest merger, which brings significant integration risk. Although we expect all CROs to benefit as pharmaceutical companies increase outsourcing in order to reduce costs, any challenges in the pharmaceutical industry are likely to reverberate through CROs. These currently include the mounting scrutiny of drug prices, which could disrupt CROs as drug companies reevaluate the potential of drugs in their pipelines. Drugs in development that cannot prove statistically significant improvement over low-cost generics or other therapeutic alternatives may be canceled, causing reduced backlogs and revenue growth rates for CROs.
Teck’s Sale of Dam Stake Boosts Liquidity

On Friday, Canadian mining company Teck Resources Limited (Ba3 positive) said it had reached a deal to sell its two-thirds interest in the Waneta Dam hydroelectric project and related transmission assets in British Columbia, Canada to Fortis Inc. (Baa3 stable) for CAD1.2 billion.

The credit-positive sale significantly bolsters Teck’s already good liquidity (SGL-2), and in light of recent volatility in commodity prices, the cash from the sale to Fortis, if left on the balance sheet, could provide Teck an important cushion on any large capital expenditures, such as the second phase of development of the Quebrada Blanca copper mine in Northern Chile. Teck estimates the project, which it will decide whether to pursue by mid-2018, will cost about $4.7 billion. Through the end of March, Teck had CAD536 million of cash and $3 billion of undrawn, committed credit facilities. The sale’s credit positive effects do not affect Teck’s credit metrics enough to change its rating, which was upgraded to Ba3 in January.

We do not anticipate the proceeds of the dam sale will be used for further debt reduction. Teck has stated it was targeting less than $5 billion of debt on its balance sheet and, having repaid about $1 billion in the first quarter of this year, the company is close to its target. We believe that Teck will use proceeds to bolster its cash position as management decides on whether to proceed with Quebrada Blanca expansion and possible financing options for the project. The Vancouver-based company had 2016 revenues of $9.3 billion from its operations in Canada, Peru, Chile and the US, which produce zinc, copper, and metallurgical coal.

Under the terms of the deal, Teck will lease back Fortis’ two-thirds interest in Waneta to produce power for its zinc and lead smelting and refining operations in Trail, British Colombia for an initial period of 20 years, with an option for a 10-year extension. Teck will make annual payments starting at approximately $75 million per year and escalating at 2% a year, which is equivalent to an electricity price of CAD40/megawatt hours based on 1,880 gigawatt hours of electricity per annum.
Vivendi’s Proposed Acquisition of Majority Stake in Havas Weakens Metrics

Last Thursday, Vivendi SA (Baa2 stable) announced that it had made an offer to purchase the approximately 60% stake that Groupe Bolloré owns in Havas SA (unrated) at a purchase price of about €2.32 billion (excluding transaction fees). Vivendi would fund the transaction with cash. Once the majority stake is acquired and in accordance with applicable law, Vivendi will launch a tender offer on the remainder of the shares at the same price.

The acquisition of Groupe Bolloré’s 60% stake would use more than half of Vivendi’s cash balance and weaken the company’s retained cash flow/net debt metric to around 32% from 160.7% at year-end 2016. However, the acquisition would not affect Vivendi’s ratings because the current Baa2 rating already reflects the assumption that the company would use a substantial portion of its cash balance for M&A.

The acquisition of Havas (which will contribute about 23% of the combined group’s EBITDA) alleviates uncertainty over the potential use of Vivendi’s cash balance and adds further diversification that strengthens Vivendi’s EBITDA margins. Still, the benefits of owning Havas rather than simply partnering with it are not fully clear to us.

Vivendi’s final stake ownership in Havas remains uncertain until the tender offer closes in late-July or early-August. Should the company’s tender offer be successful, at least in part, we expect Vivendi to fund the extra payment mostly through available cash.

On a pro-forma basis at year-end 2016, the combined group had revenue of around €13.1 billion and reported EBITDA of around €1.7 billion. At year-end 2016, Vivendi reported revenue of €10.8 billion and EBITDA of €1.16 billion. We expect Havas’ debt to remain in place since the indenture made way for a potential change of control within a Bolloré-controlled entity. On a Moody’s-adjusted basis, we expect the combined group gross debt/EBITDA to be around 3.5x at year-end 2017.

Although this is above our downward ratings guidance of 3.25x for Vivendi’s Baa2 rating, it is mitigated by the company’s large cash balance of around €1.7 billion (post acquisition of 60% of Havas) compounded by its various liquid investments (23.9% in Telecom Italia, 28.8% in Mediaset, 27% in Ubisoft and 1% in Telefonica) as well as the likelihood of achieving some EBITDA synergies between the two companies in the coming two years.

Based in Paris, France, Vivendi is an integrated content and media group. The company operates businesses throughout the media value chain, from talent discovery to the creation, production and distribution of content. Based in Puteaux, France, Havas is a global communications group. At year-end 2016, the company reported revenue of €2.28 billion and EBITDA of €377 million.
Russia’s Extension of Car Loan Subsidies Is Credit Positive for Car Dealers

On Thursday, the Russian government extended through 2017 a state programme first introduced in 2015 that subsidises interest rates for car loans. The programme is credit positive for Russian auto dealers such as Delance Limited ROLF (B1 stable) because it will support a fragile new-car sales recovery that emerged in March 2017 after more than four years of market declines.

We expect ROLF to be among the main beneficiaries because it has a diversified brand portfolio with a good coverage of the economy class segment eligible for the subsidies. As the largest player in the Russian market, the company also benefits from strong bargaining power with car manufacturers and has a well-developed complementary financial services business with established relationships with key lending banks. This allows ROLF to offer better deals and win new customers under the state support programme from its numerous smaller peers.

The government has allocated RUB10 billion (around $170 million) from the state budget to continue to compensate banks for 6.7 percentage points of prevailing car loan interest rates. As a result, the average subsidised interest rates will remain around 8%-10%, versus the current market rate of 15%-17%. Additionally, the government raised by RUB300,000 (around $5,000) the maximum price of a car eligible for the programme to RUB1.45 million (around $25,000) which will expand the range of eligible car brands and offset car-price inflation that reached 16% in 2016.

The programme was initially developed as part of state support measures introduced in 2015 to curb an accelerating decline in new car sales. Although the market down-cycle has been in place since the second half of 2012 amid a slowing Russian economy, matters worsened at the end of 2014 amid greater geopolitical tensions and a drop in oil prices, which drove a devaluation of the ruble, a fall in real disposable income and rising interest rates.

As the exhibit below shows, after a 5% decline in 2013 and 10% decline in 2014, new car sales plummeted by around 36% in 2015 and by another 11% in 2016, according to the Association of European Business (AEB). Although the government’s measures were not able to reverse the negative trend, they did provide an important support to the market that averted a much deeper decline. In particular, around 15% of total vehicles sold in 2015 and 23% of total vehicles sold in 2016 were purchased with the help of subsidized car loans.

### Russian Car Sales in Millions

<table>
<thead>
<tr>
<th>Year</th>
<th>Sales (Millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>2.9</td>
</tr>
<tr>
<td>2009</td>
<td>1.5</td>
</tr>
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<td>2010</td>
<td>1.9</td>
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<tr>
<td>2011</td>
<td>2.7</td>
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<tr>
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<td>2.9</td>
</tr>
<tr>
<td>2013</td>
<td>2.8</td>
</tr>
<tr>
<td>2014</td>
<td>2.5</td>
</tr>
<tr>
<td>2015</td>
<td>1.8</td>
</tr>
<tr>
<td>2016</td>
<td>1.4</td>
</tr>
<tr>
<td>2017</td>
<td>1.5 (Estimate)</td>
</tr>
</tbody>
</table>

Source: Association of European Business
The market likely bottomed out earlier this year, with new car sales moving in a positive direction starting in March (sales rose 9.4%, according to the AEB) amid a gradually improving economy, a more stable ruble and declining interest rates. However, the market’s recovery remains fragile given a still-weak consumer environment, and the extension of the interest rate subsidies will play a vital role in supporting the nascent trend. Overall, the AEB forecasts car sales to increase by around 4% in 2017 to 1.48 million, of which the programme should help to sell at least 350,000.
For GSK, Delay of Generic Advair Is Credit Positive

On Thursday, the US Food and Drug Administration (FDA) issued a complete response letter (CRL) to Hikma Pharmaceuticals PLC (Ba1 stable). We now believe there is a low likelihood of Hikma obtaining approval this year for a generic version of GlaxoSmithKline plc’s (GSK, A2 negative) respiratory drug Advair Diskus. The news is a major setback for Hikma, but credit positive for GSK, which will continue to derive substantial revenues from its flagship product, which contributed 12% of its total sales and 22% of its pharmaceutical sales in 2016.

The FDA’s CRL to Hikma came just a few months after Mylan Inc. (Baa3 stable) received a similar CRL related to a similar application for its own generic version of Advair. Although Mylan has not disclosed many details around its CRL, we believe both CRLs substantially reduce the risk of the FDA approving a generic substitutable version of Advair this year. A CRL is sent to the applicant when the FDA has completed its review of a drug application, but decided that the drug in question cannot be approved for marketing in its present form because of one or more deficiencies. The applicant will have to address these deficiencies before again re-submitting its application.

The absence of substitutable generic Advair competition will boost GSK’s gross margins this year because we believe that Advair is among GSK’s most profitable products. As a consequence, we expect GSK to continue de-leveraging as its EBITDA grows in 2017. We expect that this will result in positive free cash flow this year, after being negative in 2016, and will allow the company to reduce its net debt levels. GSK had previously said that in the US alone Advair revenue would fall by around 45%, or around £800 million at constant exchange rates, if a substitutable generic launched in mid-year 2017.

Hikma had previously estimated that revenues from its generics unit, which constituted 31% of 2016 revenue, would grow to around $800 million this year, fuelled by, among other things, new pipeline launches and its generic version of Advair. Following the CRL, we believe the 2017 revenue target is no longer feasible and estimate that revenues from the generics segment will be slightly above $700 million this year. Although we continue to expect that Hikma’s generic business will report better profitability over a weak 5.8% core operating margin last year, the failure to launch a generic Advair will dampen that improvement over the next 12-18 months.

Despite the delay in the launches of Mylan’s and Hikma’s generics, we believe that substitutable generic versions of Advair will come to the market, and that their financial effect will ultimately reflect the number of generics in the market and their ability to gain market share from GSK’s drug. During 2016, Advair’s US revenues shrunk by 13% following a 7% decline in volume and a 6% decrease in pricing. Even without a generic substitute, GSK has guided toward a further decline of 15%-20% in US Advair sales this year.

Hikma continues to benefit from the diversification it has as a result of its exposure to injectables, generics and branded generics. Despite the current Advair setback, we expect both injectables and generics to continue growing, resulting in mid-single-digit growth over the next 12-18 months. This should allow the company to generate positive free cash flow and continue to de-leverage (absent any external growth initiatives). With reported net debt of less than €700 million as of end 2016, Hikma maintains a strong balance sheet.
Fortescue Metals’ $1.5 Billion Senior Unsecured Note Offering Is Credit Positive

Last Wednesday, Fortescue Metals Group Ltd. (Ba1 stable) completed a $1.5 billion senior unsecured note offering. The offering has two tranches: a five-year $750 million note and a seven-year $750 million note. Proceeds from the offering will be used to repay the 2019 senior secured term loan facility and $478 million 2022 senior unsecured notes.

The debt offering is credit positive for Australia-based Fortescue because it will significantly lengthen the company’s debt maturity profile, leaving it without any debt maturing until 2022 (see Exhibits 1 and 2). Fortescue will have completely paid down the 2019 maturity of $976 million of its senior secured term loan facility. At the same time, the transaction is credit positive for senior unsecured creditors because it will significantly reduce the amount of secured debt outstanding in Fortescue’s capital structure.

**EXHIBIT 1**

Fortescue’s Debt Maturity Schedule Prior to the Offering

<table>
<thead>
<tr>
<th>Year</th>
<th>Senior Secured Notes</th>
<th>Senior Unsecured Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017</td>
<td>$1.0</td>
<td>$1.0</td>
</tr>
<tr>
<td>2018</td>
<td>$0.0</td>
<td>$0.0</td>
</tr>
<tr>
<td>2019</td>
<td>$0.5</td>
<td>$0.5</td>
</tr>
<tr>
<td>2020</td>
<td>$0.0</td>
<td>$0.0</td>
</tr>
<tr>
<td>2021</td>
<td>$0.0</td>
<td>$0.0</td>
</tr>
<tr>
<td>2022</td>
<td>$2.2</td>
<td>$2.2</td>
</tr>
<tr>
<td>2023</td>
<td>$2.0</td>
<td>$0.8</td>
</tr>
<tr>
<td>2024</td>
<td>$2.4</td>
<td>$0.8</td>
</tr>
</tbody>
</table>

Source: Company reports

**EXHIBIT 2**

Fortescue’s Pro Forma Debt Maturity Schedule Is Significantly Improved Post Offering

<table>
<thead>
<tr>
<th>Year</th>
<th>Senior Secured Notes</th>
<th>Senior Unsecured Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017</td>
<td>$1.0</td>
<td>$1.0</td>
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<tr>
<td>2018</td>
<td>$0.0</td>
<td>$0.0</td>
</tr>
<tr>
<td>2019</td>
<td>$0.5</td>
<td>$0.5</td>
</tr>
<tr>
<td>2020</td>
<td>$0.0</td>
<td>$0.0</td>
</tr>
<tr>
<td>2021</td>
<td>$0.0</td>
<td>$0.0</td>
</tr>
<tr>
<td>2022</td>
<td>$2.2</td>
<td>$2.2</td>
</tr>
<tr>
<td>2023</td>
<td>$0.8</td>
<td>$0.8</td>
</tr>
<tr>
<td>2024</td>
<td>$2.4</td>
<td>$0.8</td>
</tr>
</tbody>
</table>

Source: Australian Securities Exchange
The latest capital management initiative follows approximately $2.7 billion repaid so far in fiscal 2017, which ends 30 June, and $2.9 billion repaid in fiscal 2016. The company’s continued debt reductions decreased its reported total debt to around $4.3 billion as of 31 March 2017, from around $6.8 billion as of 30 June 2016. This is close to a 67% reduction from Fortescue’s peak debt level of around $12.7 billion in fiscal 2013 (see Exhibit 3). As a result of the significant debt reductions and improved iron ore prices during the first-half of this fiscal year, Fortescue’s leverage, as measured by adjusted debt/EBITDA, improved significantly to around 1.2x for the 12 months that ended 31 December 2016 versus 2.2x for fiscal 2016.

We expect that Fortescue’s significant debt reduction will enable it to better withstand iron ore price declines. The benchmark 62% iron ore price has rebounded strongly so far in fiscal 2017, to a peak level of around $95/tonne in February 2017. However, as we expected, it has since trended down toward our base case assumption of $60/tonne for 2017. We use this pricing assumption as the base case for our financial projections. The iron ore price has averaged around $71/tonne for year-to-date fiscal 2017 and is currently around $60/tonne. Our base case assumption for the iron ore price is $55/tonne in 2018.

Notwithstanding Fortescue’s debt repayments during fiscal 2017, liquidity remained solid in the period with cash balances remaining at around $1.5 billion as at 31 March 2017. With Fortescue’s break-even costs currently around $30/tonne, following multi-year efficiency initiatives, we expect it to continue to generate solid cash flow under our base case assumptions for iron ore prices in 2017-18.
Crown Resorts’ Sale of Its Remaining Stake in Melco Resorts Is Credit Positive

On Tuesday, Crown Resorts Limited (Baa2 stable) announced that its wholly owned subsidiary Crown Investments Pty Ltd (CAI) will sell its remaining 11.2% interest in Melco Resorts & Entertainment Limited (unrated) back to Melco Resorts. The cash proceeds of approximately AUD1.34 billion will bolster Crown Resorts’ already strong liquidity and provide an additional buffer for its expected ramp up in spending on its Crown Sydney project.

At the same time, conditional on completion of the sale, Crown Resorts has agreed to unwind each of the cash-settled equity swaps CAI entered in December 2016 and Crown Resorts entered in March 2017. The purpose of these cash-settled equity swaps was to hedge the price of its share sale in Melco. On completion of the sale and as a result of the swap unwind transactions, Crown Resorts expects to generate net proceeds of approximately $987 million, or AUD1.34 billion.

This stake sale follows Crown’s earlier sale of a 13.4% stake in Melco, which it completed in February. Crown previously announced that it would use AUD800 million of that sale’s roughly AUD1.6 billion of proceeds towards debt reduction.

Crown has been actively reducing its gross indebtedness and we expect that the company will balance the use of the proceeds from this sale between debt reduction, shareholder returns and investment opportunities. Earlier this month, Crown announced that it had repaid AUD128 million of its subordinated Hybrid Notes I and announced an offer to repurchase all or some of its AUD450 million of medium term notes due 2019.

If a substantial portion of the proceeds from this transaction were to be applied toward sustained debt reduction, it would strongly improve Crown’s credit metrics, particularly since its revenue and EBITDA as of the first half of fiscal 2017 (which ended 31 December 2016) were substantially lower than first half of fiscal 2016 largely because its International VIP program play revenue declined following the detention of its employees in China in October 2016. We expect weak International VIP performance to continue to negatively affect Crown’s revenue and earnings in the second half of fiscal 2017.

On completion of the 11.2% stake sale, Crown Resorts will have completely disposed of its ownership in Melco. We do not expect this to have a material earnings effect on Crown given our view that the probability of a strong and sustainable rise in dividend income from Melco is currently low. The operating environment in Macau’s gaming market remains challenging. We had expected the company to receive dividends between AUD40-AUD60 million from Melco for fiscal 2017 before these transactions, but the effect on credit metrics will be more than offset by the positive effect of debt reduction.
Toyota's Weakening Profitability in 2016 and Outlook for More Weakening Are Credit Negative

On 10 May, Toyota Motor Corporation (Aa3 stable) announced its preliminary financial results for fiscal 2016, which ended 31 March 2017, and its estimates for fiscal 2017, including its expectation for further margin contraction in the next 12 months. Toyota’s expectation of weakening profitability and a resulting reduction in free cash flow are credit negative for the automaker.

Toyota estimates its consolidated operating margin (including the finance business) will drop to 5.8% in fiscal 2017 from 7.2% in fiscal 2016 and 10% in fiscal 2015. Toyota’s expectation of margin decline in fiscal 2017 reflects several factors. Raw material costs, including steel, will be higher this year and largely cancel out positive effects from cost cuts, which will be similar in size to last year’s cost cuts. Rising sales incentives in North America amid sluggish unit-sales growth in that market also lower profitability. We expect the adjusted EBITA margin for Toyota’s automotive business (excluding the finance business) will weaken by one or two percentage points in fiscal 2017 from 8.3% in fiscal 2016.

The strengthening of the Japanese yen against the US dollar will also continue to reduce the profitability of Toyota’s exports, although the company expects the appreciation and resulting drag on profitability to be smaller in fiscal 2017 than in fiscal 2016. Toyota’s profitability declined in fiscal 2016 owing largely to the yen strengthening against the US dollar and weaker emerging-market currencies against major currencies, which raised input costs for the company’s operations in developing countries.

Toyota expects expenses for recalls and other product quality-assurance costs will decline in fiscal 2017 along with provisions mainly for those related to defective airbags manufactured by Takata Corporation (unrated).

Nonetheless, Toyota plans to increase capital spending this year after decreasing it last year. Higher spending reflects increased adoption of the Toyota New Global Architecture, which promotes production efficiency. Although this investment is likely to benefit Toyota’s future margins, the higher capital spending will reduce the company’s free cash flow (FCF) and its adjusted FCF/debt ratio in fiscal 2017 from 21.4% in fiscal 2016, which declined from 42.4% in fiscal 2015 on the back of lower net income.

We estimate Toyota’s adjusted debt/EBITDA was 1.0x and debt/capitalization was 16.1% in fiscal 2016, based on the company’s preliminary financials. We expect the company will manage these ratios near these levels this year.
Infrastructure

For Calpine, a Private-Equity Buyout Would Be Credit Negative

Last Wednesday, The Wall Street Journal reported that unnamed private-equity firms are in talks with Calpine Corporation (Ba3 stable) to acquire it. A private-equity buyout would be credit negative for Calpine because private-equity firms typically use financial leverage to boost investment returns and generally implement capital structures that result in B-rated corporate family ratings.

The merchant power sector to date has had only two private-equity buyouts of major publicly listed companies, and in both cases aggressive financial leverage and financial policies led to credit deterioration and subsequent rating downgrades. In 2007, Kohlberg Kravis Roberts’ buyout of TXU Corp. resulted in our downgrading TXU’s unsecured bonds to B3 from Ba1. The company, which was renamed Energy Future Holdings, filed for bankruptcy in 2014. In 2016, an affiliate of private-equity firm Riverstone Holdings LLC acquired Talen Energy Corp. and its rated subsidiary Talen Energy Supply LLC (Talen, B1 stable). We later downgraded Talen’s rating to B1 from Ba3 because the new management used essentially all of Talen’s cash holdings plus some additional debt to buy out the firm, rather than using a portion of the cash to pay down maturing debt as the previous management planned to do.

Calpine has had high debt leverage, with its cash flow to debt ratio in the high single digits, substantially below our quantitative guidance of 12%-20% for the Ba rating category. But the current management has committed to use most of its upcoming free cash flow to reduce debt by $2.7 billion by the end of 2019. We would not expect this financial policy to continue under private-equity ownership.

A private-equity buyout is not assured because of certain bond indenture or loan agreement requirements. A majority of Calpine’s bonds and loans have a change-of-control clause that requires the company to redeem the debt if both we and Standard & Poor’s downgrade the debt’s rating. It would probably be cost prohibitive for Calpine to refinance most of its debt to complete the transaction.

Private-equity firms are likely to remain interested in buying out publicly listed merchant power companies because they are trading at low valuations and because publicly listed companies are small enough with market capitalizations in the $1.0-$6.5 billion range that private-equity firms do not have trouble raising the funds necessary for a buyout.
Banks

**US Treasury’s Sale of Remaining TARP Stake in First BanCorp Is Credit Positive**

Last Wednesday, the US Department of the Treasury announced that it had agreed to sell all of its remaining 10,291,553 common shares, equal to about 4.8% of total common shares, in First BanCorp (unrated), the bank holding company for FirstBank Puerto Rico (B1/Caa1 stable, b3′), thereby exiting its investment in the bank’s Troubled Asset Relief Program (TARP). This development is credit positive because it is another milestone in FirstBank’s ongoing recovery from the financial crisis and an indication that regulators are more comfortable with the bank’s capital and liquidity position and its improved ability to access public markets.

In June 2016, FirstBank received approval to bring current and begin paying quarterly dividends on its $216 million of outstanding trust preferred securities (TRUPs) that it had deferred since March 2012. In December 2016, the bank received approval to resume the monthly cash dividend on its $36.1 million of outstanding non-cumulative preferred shares that had been suspended since 2009. The bank has paid both the quarterly TRUP dividend and monthly preferred dividend for every period since.

On 5 December 2016 and 1 February 2017, funds affiliated with Thomas H. Lee Partners, L.P. and Oaktree Capital Management, L.P. that were instrumental in the bank’s 2011 recapitalization sold down a portion of their ownership stakes through secondary public market offerings. Their combined holdings declined to just under 20% from 30% in the February sale, and from their original 49% stake. Last Wednesday’s sale by the Treasury opens the bank’s shares further to the public markets.

The Treasury’s sale also signals another step toward restoring FirstBank’s common dividend, although the bank remains subject to a written agreement with the US Federal Reserve that requires regulatory approval to do so, as well as to make payments on its preferred shares, TRUPs and subordinated debt. The Treasury also still holds a warrant to purchase additional shares in FirstBank.

FirstBank has generated positive earnings for seven consecutive quarters and its capital ratios are high. Exhibit 1 shows the rising trend in the bank’s capital ratios, which have been boosted by retained earnings.

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1 The bank ratings shown in this report are the banks’ deposit rating, issuer rating and baseline credit assessment.
EXHIBIT 1
FirstBank Puerto Rico’s Tangible Common Equity/Risk-Weighted Assets
The ratio has risen as a result of retained earnings and asset shrinkage.

Nevertheless, FirstBank is not out of the woods: the bank’s improved capitalization partly reflects a contraction of its balance sheet, a result of Puerto Rico’s poor economy. We expect Puerto Rico’s economy, which has been in recession since 2006, to continue to contract for at least the next two years, harming the bank’s asset quality and earnings. This limits the bank’s ability to build capital from retained earnings.

Puerto Rico’s economic challenges are exacerbated by its high debt burden and ongoing liquidity crisis. Although the federally appointed Financial Oversight and Management Board for Puerto Rico has presented its fiscal plan, the board has yet to finalize a blueprint to help Puerto Rico restructure its debt or embark on a sustainable path to economic recovery. Moreover, austerity measures will certainly be taken to enable Puerto Rico to meet its debt burden that could have a dampening effect on the economy over the next few years.

In that context, FirstBank’s high level of problem assets will require further loan-loss provisions if the economy deteriorates more than expected. Of the Puerto Rican banks we rate, FirstBank holds the largest amount of problem loans. Exhibit 2 shows that although the problem-loan ratios in recent years have declined at FirstBank and the other rated Puerto Rican Banks, Banco Popular de Puerto Rico (Ba2/B2 stable, b1) and Banco Santander Puerto Rico (A2/Baa2 stable, ba3), their ratios remain stuck at high levels relative to their US peers.
EXHIBIT 2
Puerto Rican Banks’ Problem Loans/Gross Loans, 2011 to First-Quarter 2017
The banks’ ratios are high relative to their US peers.

Sources: Moody’s Financial Metrics and banks’ 10Ks, 10Qs, FR-Y9C reports and presentations
US Banks’ Tightening Lending Standards on Commercial Real Estate Are Credit Positive

Last Monday, the US Federal Reserve (Fed) published its quarterly Senior Loan Officer Opinion Survey. The survey showed that on balance, US banks tightened lending standards on commercial real estate (CRE) loans. There was also a special set of questions in which banks reported tightening most credit policies on CRE loans over the past year. A modest proportion of banks reported weaker demand for all three major types of CRE loans, which was evident in first quarter CRE loan growth slowing from 2016. The survey results are credit positive because they demonstrate that US banks are responding to less favorable CRE market conditions with controlled loan growth, which should help them manage credit costs and keep their risk profiles in check.

For the seventh consecutive quarter, US banks reported net tightening of CRE credit standards (Exhibit 1), which is a positive trend. Most respondents indicated tightening for construction and land development and for multifamily loans, and in both cases, the percentage of banks tightening credit was higher than the prior quarter. For nonfarm nonresidential properties, the respondents’ net tightening was more moderate and slightly down from the first quarter.

Tightening underwriting standards is credit positive because certain leading indicators suggest problem CRE loans and credit losses will increase and continued tightening will afford the banks more loss protection. For example, a good predictor of problem loans has been the ratio of CRE loans to US GDP, and this has increased one percentage point over the past two years to 20% as of fourth-quarter 2016. Similarly, our loan-to-value ratio for commercial mortgage-backed securities has been above 100% since 2013. It reached 118% at year-end 2016, which is a level not seen since prior to the Great Recession, signaling that the CRE market has heated up.

**EXHIBIT 1**

Net Percent of Domestic US Bank Survey Respondents Tightening Loan Standards by CRE Loan Category

[Graph showing net percent of domestic US bank survey respondents tightening loan standards by CRE loan category, with data for different quarters from 2014 to 2017.]

Source: Federal Reserve
The Fed survey included a special set of questions. The first three questions asked about how the banks have changed credit policies over the last year for each CRE category. The most significant share of banks reported wider loan spreads (meaning tightening) and lower loan-to-value ratios, which is a key protection against loss. This was most significant in construction and land development and multifamily loans. The fourth question asked banks about their reasons for tightening or easing their CRE credit policies over the past year. Among the reasons for tightening CRE credit policies, the most participants (22.9%) thought a less favorable or more uncertain outlook for vacancy rates or other fundamentals on CRE properties was very important to their decision, while reduced risk tolerance was a close second (20.4%).

The survey also showed a modest proportion of banks reported weaker demand for all three types of CRE loans, which was evident in first quarter CRE loan growth. CRE growth at many of the large US banks slowed in the first quarter of 2017 as shown in Exhibit 2. For several, the CRE loan balance declined, a likely result of their tightening of underwriting standards referenced in the Fed survey.

EXHIBIT 2
Commercial Real Estate Loan Growth, 2016 and First-Quarter 2017

Source: Company reports
Itaú’s Investment in XP Investimentos Is Credit Positive

On Thursday, Brazil’s largest private bank Itaú Unibanco S.A. (Itaú, Ba2/Ba2 stable, ba2) announced that, pending regulatory approval, it will acquire 49.9% of the shares of XP Investimentos (XP, unrated), a leading independent brokerage and asset management group, for approximately BRL6.3 billion ($2 billion), including a capital injection of BRL600 million ($190 million). In addition, Itaú will have the option to increase its stake to 74.9% in two rounds of 12.5% in 2020 and 2022. The price implies a BRL12 billion ($3.8 billion) valuation.

The acquisition of XP’s full-service online broker-dealer is credit positive because it positions Itaú as a leader in the fast-growing online financial services segment in Brazil. We expect the rapid growth of online, flexible and low-cost financial advisory services to increasingly pressure banks’ traditional customer relationships.

XP’s well-established distribution platform will also provide Itaú with a new source of robust earnings generation. The investment is the latest of Itaú’s recent series of strategic investments in fee-based growth areas and will help offset the effect of Brazil’s declining interest rates, which threatens to squeeze the bank’s interest income.

In first-quarter 2017, asset management activities accounted for 16.7% of Itaú’s total fee-based income, which was 55% of Itaú’s consolidated recurring net income. XP had just BRL85 billion in assets under custody and BRL8.2 billion in managed assets, compared to Itaú’s BRL1.3 trillion in assets under custody and BRL546 billion in assets under management, but XP brings a strong share of the equity-trading market.

The acquisition complements Itaú’s digital banking strategy to develop innovative banking solutions and accelerate the bank’s digital transformation process. Last March, Itaú launched 360, a digital platform to offer high-income customers a wider range of third-party investment products and compete with an increasing number of digital investment platforms such as BTG Digital (unrated) of Banco BTG Pactual S.A. (BTG, Ba3/Ba3 stable, ba3), Banco Original S.A. (B1 stable, b1) and Sofisa Direto (unrated) of Banco Sofisa S.A. (Ba2 stable, ba2).

The transaction is also a positive development for XP Gestão de Recursos Ltda. (unrated), the asset management division of XP Group (unrated), because Itaú will bring another layer of surveillance and further strengthen the company’s operations and controls procedures. We expect that XP Gestão’s disciplined investment decision-making process, its effective risk management controls and its strong market position will be maintained.

The acquisition will lead to an 80 basis point (bp) drop in Itaú’s reported common equity Tier 1 capital ratio, which stood at a robust 14.7% (fully loaded Basle 3) at the end of the first quarter. Although our preferred measure of capitalization, tangible common equity/risk-weighted assets, will decline approximately 110 bp to 8.8%, it will remain above the bank’s main peers. Itaú should be able to easily reverse these declines in short order given strong internal capital generation that has averaged 150 bp a year for the past three years, and which we expect the acquisition will boost further.

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2 The bank ratings shown in this report are the bank’s domestic deposit rating, senior unsecured debt rating (where available) and baseline credit assessment.
4 This estimate considers the acquisition of retail banking platform of Citibank N.A. (A1/A1 stable, baa2) subsidiary in Brazil, Banco Citibank S.A. (Ba3 stable, ba2), announced in November 2016, which will reduce CET1 ratio by 40 bp, and still waits for regulatory approval.
The current controlling group led by founder and CEO Guilherme Benchimol will remain in place and have 50.1% of voting shares. The other minority shareholders, global equity firm General Atlantic (unrated) and Brazilian broker Dynamo (unrated), will gradually sell their stakes to Itaú until they leave the company in 2022. Itaú will appoint two of the seven-member Executive Board.
Mitsubishi UFJ Financial Group’s Investment in Mitsubishi Credit Card Company Is Credit Positive

Last Thursday, the Nikkei announced that Mitsubishi UFJ Financial Group, Inc. (MUFG, A1 stable), Japan’s largest banking group, will acquire Norinchukin Bank’s (A1/A1 stable, baa1) 15% stake in the credit card company Mitsubishi UFJ NICOS Co., Ltd. (MUN, unrated), turning it into a wholly owned subsidiary. We estimate the transaction will cost MUFG approximately ¥50 billion.

MUFG’s credit-positive acquisition of 100% of MUN will give it complete control to determine the strategic direction of its credit card operations, which have more than 17 million members. Control will give MUFG the flexibility to integrate the systems of its DC, MUFG and Nicos cards, and result in lower operating costs because of improved cost synergies.

MUFG will also be able to position MUN as its core system to manage its cashless payments. Last December, MUN made its credit cards compatible with Apple Pay and MUFG is now preparing to issue its own virtual currency, MUFG Coin, which uses blockchain technology. MUFG expects applications of MUFG Coin to include withdrawals, deposits and foreign exchange via smart phones at lower fees compared to existing banking commissions.

In addition, the increased stake in MUN will enhance MUFG’s profits and profitability through increased fee income. MUN’s profitability, as measured by return on assets, has averaged more than double that of MUFG over the five years to fiscal 2015, which ended 31 March, as shown below.

Furthermore, as part of the agreement, MUFG and Norinchukin Bank will set up a separate company to run JA Card, which is the credit card MUN presently offers and issues via the agriculture cooperatives affiliated with Norinchukin Bank, and has about 2 million members. Norinchukin Bank will become the majority shareholder in this new company.

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5 The ratings shown are Norinchukin Bank’s deposit rating and senior unsecured debt rating, and its baseline credit assessment.
Mauritian Banks Will Benefit from Increased Tourism

Last Monday, the government statistics office in Mauritius released data that showed international tourist arrivals had risen 7.5% in the first four months of 2017 over year-earlier levels, and had increased 21% in April 2017 over April 2016 levels. The growth in tourist arrivals is credit positive for Mauritius’ local banks’ asset quality and profitability because it will support the repayment capacity of borrowers in the hospitality and related sectors, promote employment and support economic growth.

In the first four months of 2017, around 451,000 tourists visited Mauritius, up from 420,000 a year earlier (see Exhibit 1). The increase in tourist arrivals will benefit Mauritius Commercial Bank Limited (MCB, Baa3/Baa3 stable, ba1) and SBM Bank (Mauritius) Ltd. (Baa3 stable, ba1), which are the two largest domestic banks financing the tourism sector.

Although Mauritius is a well-diversified economy, tourism remains a key pillar of this small island country with a population of 1.3 million and GDP of around $12 billion in 2016. According to the World Travel and Tourism Council, tourism directly accounted for 8.4% of GDP and 8.2% of employment in 2016, while its total contribution including indirect and induced effects on the economy was significantly higher at 25.6% and 24.3%, respectively.

Growing tourism will positively affect borrowers’ cash flows in the hospitality and related sectors such as transport, construction and food, and lead to job creation (unemployment in Mauritius was 6.6% in the fourth quarter 2016). Banks’ ratio of nonperforming loans to gross loans was an elevated 7.1% as of June 2016, which, along with low credit demand and weak loan growth, constitute banks’ main challenges and credit constraints.

Mauritian banks’ exposure to tourism was significant at around 15% of total credit as of December 2016 (see Exhibit 2). MCB’s exposure to tourism was 19% of total loans in June 2016, while for SBM it was 13% as of December 2016. Although the direct sector exposures are relatively high, the ratio of impaired loans to gross loans for the tourism sector were manageable at 2.4% for MCB as of June 2016 and 0.2% for SBM as of December 2016.
Greater tourism will also support banks' profitability by bolstering credit growth, which has been negative for the system in the past two years. As a result, banks in Mauritius maintain high liquidity, with liquid assets at 39% of total assets as of December 2016. Such robust liquidity is likely to be directed into higher yielding loans in 2017-18, with tourism, construction and infrastructure projects at the forefront of this loan growth.

Banks' profitability has been challenged in recent years, with the banking system's average return on assets declining to 1.2% for the year ending June 2016 from 1.4% the year before. The decline in profitability was the result of, among other things, elevated loan-loss provisions triggered by banks' efforts to expand their foreign-related business given scarce domestic lending opportunities. We expect that the stronger tourism sector will give a boost to GDP growth in 2017, which we expect will be around 3.6% (Statistics Mauritius projects 3.9%), providing increased loan growth potential.
AXA’s IPO of US Life Unit Would Be Credit Negative for AXA Financial

On 10 May, AXA SA (A2 stable), a French-based multi-line insurer, announced that it intends to pursue a partial IPO of its US life unit AXA Financial Inc. (Baa1 negative), which also owns 64% of the asset manager AllianceBernstein (A2 stable). The partial IPO is credit negative for AXA Financial and its insurance operating subsidiaries because it presages diminished support from AXA. Following the announcement, we downgraded the senior unsecured debt rating of AXA Financial to Ba1 from A2. The effect on AllianceBernstein is credit neutral, given that it does not significantly rely on support from the parent.

AXA is one of the world’s largest insurance groups, with €1.4 trillion in assets under management at year-end 2016. The group said that it intends to list a minority stake of its US operations in the first half of 2018, subject to market conditions. The US operations have well established positions in the individual annuity and life insurance markets, serving more than 2.5 million customers. Within AXA’s Life & Savings segment, AXA Financial contributed 23% of 2016 economic gross revenues and 26% of underlying earnings (see exhibit).

According to AXA, listing the US operations would create an option to reduce its exposure to financial risks while strengthening its economic capital position. Proceeds from the transaction will be reinvested in what AXA sees as its priority lines of business, including health, protection and P&C commercial lines, and/or potential returns to shareholders depending on acquisition opportunities and market conditions.

AXA Financial and its insurance subsidiaries benefit from the implicit support that they receive from AXA. AXA’s decision to pursue an IPO of its US operations raises questions about the strength of that support. Following the announcement, we also downgraded AXA Equitable Life Insurance Company financial strength to A1 from Aa3 and affirmed MONY Life Insurance Company of America financial strength rating at A1.
In addition to uncertainty about AXA’s degree of support to AXA Financial and its subsidiaries, during the transition period AXA Financial may face challenges owing to its increased independence. For example, there is uncertainty about the branding going forward, and whether the US operations will keep the AXA name. Given the strength of the AXA brand, any move away from the brand would weaken AXA Financial’s credit quality. Over the next 12-18 months, we will consider the performance of the business, any actual or contemplated changes in parental ownership levels as well as other forms of implicit and explicit support.

By divesting from its US life insurance business, albeit only partially, AXA joins other European insurance companies that have exited the US life insurance market. Old Mutual Plc (Baa3 review for downgrade) sold its US life business in 2010, and ING Groep N.V. (Baa1 stable) and Aviva Plc (A3 stable) divested from their US operations in 2013. Although each divestiture was the result of unique circumstances, Europe’s strict capital requirements under Solvency II for products containing financial risks have been a recurring force driving these separations. We view AXA’s economic capitalization as lower quality than some of its Aa-rated peers, since its reported Solvency II ratio is significantly inflated by the use of equivalence for the group’s US business. Equivalence allows companies to use National Association of Insurance Commissioners’ risk-based capital ratios for their US operations when determining their group’s reported Solvency II ratio instead of the more stringent capital models required in Europe.
Sovereigns

Credit Implications of New French Presidency Will Depend on Ability to Reach Consensus on Economic and Fiscal Policy

As widely expected, Emmanuel Macron was elected president of France (Aa2 stable) after winning 66.1% of the votes in the second round of the elections on 7 May. As a former minister for the economy who founded his centrist En Marche! movement in April 2016, Mr. Macron’s victory means that, for the first time, the president of the French republic does not come from one of the country’s traditional establishment political parties. Overall, the credit implications of Mr. Macron’s election will be heavily influenced by his ability to reach consensus on economic and fiscal policy proposals.

President Macron’s new administration faces material fiscal and economic challenges in the form of high debt and weak growth. The ability to design and implement policies that enhance growth and fiscal consolidation will determine the trajectory of France’s credit quality. Mr. Macron’s reform-focused policy agenda is credit positive, provided he is able to implement reforms and achieve the targeted improvement in growth and debt consolidation, which would in turn improve France’s economic strength.

Mr. Macron campaigned on a centrist reforming platform that could achieve important changes to labour market regulation and competitiveness. Mr. Macron has also advocated a lower corporate tax rate, lower local taxes, and lower social contributions from companies and individuals. On balance, his fiscal plans would, if executed, result in a fairly modest €10 billion in net savings (less than 0.5% of GDP) over the period to 2022. Mr. Macron has also pledged that the deficit will remain below 3% of GDP over his five-year term. He plans €50 billion in investment spending on education, the environment, health and agriculture and €60 billion in savings from health, reduced unemployment benefits, and cuts to overall government spending at both the central and local levels.

However, the outcome of legislative elections in mid-June will determine Mr. Macron’s ability to implement reforms. Given that Mr. Macron’s En Marche! political alliance is very new, it is unlikely to gain the 289 deputies required to hold an absolute majority. The most likely outcome is therefore either a period of “cohabitation,” whereby the president comes from a different political party than the majority of members in the assembly, or a cross-party coalition.

» In the event of a cohabitation, domestic policy would be the responsibility of the prime minister, who would likely come from the party with a parliamentary majority, based on France’s previous three periods of cohabitation. In such a scenario, Mr. Macron’s domestic policy views would be less directly relevant, although his centrist policy stance means that he could potentially find common cause with a centre-left or centre-right government on an issue-by-issue basis. However, there is a very material risk that a period of cohabitation during a Macron presidency could prevent France from implementing policies that would address its growth and fiscal challenges.

» Given the disillusionment with traditional political parties, it is also possible that no party will win an absolute majority of seats in parliament, in which case a centrist coalition government could be formed. In this case, President Macron and the government would be more likely to find common cause, potentially opening the way for some reforms that could address some of the economic and budgetary pressures facing the country.

Whatever political constellation is agreed – be it a cohabitation or a cross-party coalition – Mr. Macron’s ability to address France’s fiscal and economic challenges depends on support from parliament. If the president and parliament fail to reach an accommodation, France could face five years of drift, undermining its sovereign credit profile.

This is a summary of a longer article that can be found here.

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Slovenia’s Launch of Debt Buyback Is Credit Positive

Last Tuesday, Slovenia (Baa3 positive) launched a cash tender to buy back outstanding US dollar-denominated securities due in 2022-24 in order to reduce debt-servicing costs, building on last year’s three successful buybacks of US dollar-denominated securities. The offers are credit positive because they will lower the sovereign’s cost of debt.

Slovenia issued these bonds during 2012-14, when the country was in the midst of a domestic-driven banking crisis. Issuing securities with coupons of 5.25%-5.85%, the sovereign increased its reliance on external financing because euro-denominated debt was expensive. As a result, Slovenia’s share of euro-denominated central government debt decreased significantly, falling to 73% at the end of 2014 from 99.8% at the end of 2011. The opportunity to lower interest costs led Slovenia’s Ministry of Finance (MoF) to take advantage of improved investor confidence and low euro yields related to the European Central Bank’s quantitative easing programme.

Between May and October 2016, Slovenia issued Eurobonds to buy back US dollar-denominated debt. The MoF bought back $2.61 billion of bonds issued during 2012-14 (about 30% of Slovenia’s total US dollar-denominated debt) that will deliver lifetime interest savings of €66 million. The savings equalled 0.2% of GDP in 2016, contributing to a reduction of interest to GDP to 3.2% in 2016 from 3.3% in 2015 and increasing the government’s debt-weighted average maturity to 8.1 years at the end of 2016 from 5.7 years at the end of 2015.

At the same time, the MoF was successful in issuing cheaper eurobonds. For example, in October 2016 Slovenia issued a 24-year €1 billion tap issue at a very low yield of 1.863%. This issuance increased the share of central government debt denominated in euros to 81.5% of total central government outstanding debt at the end of 2016 from 73% at the end of 2014.

The MoF is revisiting its strategy of optimizing debt servicing costs with the launch of the cash tender offer. Given the uncertainty around the offer amount, the extent of interest savings that it will achieve is difficult to estimate, but we have included lower interest payments in our fiscal forecasts for this year (see exhibit).

Slovenia’s Interest/GDP and Interest Payments
A successful debt management strategy reduced interest payments from high levels.

Sources: Eurostat and Moody’s Investors Service

Slovenia also benefits from a large cumulated cash buffer equivalent to around 15% of GDP as a result of pre-financing in a period of low yields. The government drew down some of it last year and will do so again over the course of this year, thus prompting a larger debt reduction than would be implied by deficit levels, interest rates and growth.
Saudi Arabia Publishes Its First Quarterly Budget Update, Improving Transparency

On Thursday, Saudi Arabia’s (A1 stable) Ministry of Finance published its first ever quarterly budget update, covering the first three months of 2017. Quarterly budget updates help credit analysis because they allow for more frequent monitoring of the government’s fiscal position and provide comparisons against the government’s published targets. The publication of in-year reports offers a clear insight into how expected revenues and expenditures are evolving, providing an early indication of upward or downward pressure on the sovereign’s fiscal position.

Saudi Arabia has moderate scores in transparency and governance indices, but budget transparency has been a particular weakness, with the government scoring a zero out of a maximum 100 in the latest Open Budget Survey from 2015. Following initial steps last year, such as the publication of a detailed budget document for 2017 and a medium-term fiscal balance program until 2020, publishing a quarterly budget update marks a significant improvement in transparency and accountability, and another step toward achieving the targets set out in the sovereign’s National Transformation Program 2020 (NTP) and National Vision 2030.

National Vision 2030 outlines long-term goals, such as increasing the share of the non-oil private sector in the economy, reducing the reliance on the public sector as the main source of employment, and further structural improvements to the business environment. NTP is one implementation program to reach the Vision 2030 goals, and improving transparency is key to these plans. For instance, one strategic objective for the Ministry of Finance in the NTP is to strengthen public financial governance by reaching a score of 25 in the Open Budget Survey by 2020 as a key performance indicator, an ambitious target given its currently low position. The Ministry of Finance is also targeting the application of the International Monetary Fund’s Government Financial Statistics system to 80% of government entities by the same deadline, from 30% currently.

Higher frequency reporting will also support improved accountability for Saudi Arabia’s fiscal accounts, particularly as the country navigates a more challenging fiscal era relative to its history. Elevated volatility in the oil market in recent years has introduced a greater risk of revenue missing targets to the upside and downside, thereby requiring constant monitoring.

Achieving these goals improves the likelihood that Saudi Arabia can reach other transparency goals, including the publication of reports on the government’s payment performance to contractors (with the goal of having no payment delays beyond 60 days) and public announcement of key performance indicators for government entities involved in NTP. If Saudi Arabia can sustain its fiscal reform momentum, it would bode well for the implementation of the authorities’ long-term fiscal goals, including a gradual reduction of public-sector wages relative to total spending and diversifying the economy and government revenue away from the oil sector. Additionally, improving transparency brings other benefits, including to help support deepening foreign investment in the economy.
Egypt Will Benefit from the IMF’s Vote of Confidence in Sovereign’s Reform Effort

On Friday, the International Monetary Fund (IMF) issued a press release announcing a staff-level agreement for the completion of the first review of Egypt’s (B3 stable) Extended Fund Facility (EFF), which was delayed by about two months from the original timeline. The IMF’s successful review is credit positive for Egypt because it paves the way for another disbursement of about $1.25 billion once the IMF’s executive board approves it, which we expect in the next one to two months. It also affirms Egyptian authorities’ commitment to reforms that will support a gradual improvement of Egypt’s fiscal and external vulnerabilities.

The IMF board approved a $12 billion, three-year EFF in November 2016, followed by an immediate first-tranche disbursement of $2.7 billion. The major reform areas under the EFF include exchange-rate liberalization, tightened monetary policy to control inflation, strong fiscal consolidation to achieve public debt sustainability and structural reforms to ensure social stability and promote growth and job creation.

The government’s most recent reform steps include parliamentary approval of new industrial licensing and investment laws; a draft budget for fiscal year 2018 (which ends 30 June 2018) that includes a planned hike in the value-added tax (VAT) rate to 14% from 13%; and strengthened social safety measures that will support social stability and help counterbalance the negative effects from a temporary spike in inflation rates.

Earlier reform measures, including exchange-rate liberalization in November, are showing positive effects. Abandoning the peg to the US dollar and moving toward a free-floating exchange rate, along with additional external bilateral, multilateral and market funding, increased net international reserves at the Central Bank of Egypt to $28.6 billion in April, the highest level since March 2011 (see exhibit). The increase lowers the risk of a renewed balance-of-payments crisis, and with the concurrent relaxation of foreign exchange controls, has helped to increase the supply of foreign currency, which supports economic activity.

Egypt’s Net International Reserves

Sources: Central Bank of Egypt and Haver Analytics

Despite the sharp pick-up in inflation since November 2016 as a result of the currency depreciation and fiscal measures such as further subsidy reforms and introduction of the VAT, the economy has held up reasonably well. Egypt’s year-on-year real GDP growth was 3.8% in the second quarter of the current fiscal year (October-December 2016) and 3.9% in the third quarter, up from 3.4% in the first quarter.
Economic recovery and fiscal consolidation as a result of further reform implementation will gradually reduce Egypt’s high government debt burden of more than 90% of GDP, and huge borrowing needs as a result of elevated fiscal deficits and a short average term to maturity for outstanding debt. From a balance-of-payments perspective, additional rebalancing of foreign-exchange inflows toward goods and services exports and foreign direct investment would solidify the improvements Egypt has achieved so far.
Securitization

**Australia's RMBS Will Benefit from Proposal to Expand Regulator's Powers over Mortgage Lending**

Last Tuesday, the Australian government announced as part of its budget that it would legislate to extend the Australian Prudential Regulation Authority's (APRA) powers to allow it to regulate lending by non-bank financial institutions and apply different macro-prudential policies to different parts of the country. The new policy, if passed by the Australian parliament, would be credit positive for Australian residential mortgage-backed securities (RMBS) because extending APRA’s powers to cover non-banks would curb riskier mortgage lending by non-bank lenders amid rising housing prices, thereby reducing risks in RMBS portfolios.

Empowering APRA to apply different macro-prudential policies to different regions would allow the regulator to target specific parts of the country where the property market and lending activity pose the most risk.

Non-bank lenders have significantly increased their origination of riskier housing investments and interest-only mortgages over the past two years, a period over which APRA has introduced measures aimed at limiting growth of such loans by banks and other authorised deposit-taking institutions (ADIs). APRA currently regulates banks and other ADIs, but does not regulate lending by non-bank financial institutions. Instead, regulatory oversight of the non-bank sector is presently the responsibility of the Australian Securities and Investments Commission, which enforces responsible lending but does not have the power to implement macro-prudential policy measures.

Extending APRA’s powers to cover non-banks would allow the regulator to set limits that ensure that the loan quality from these lenders is not materially worse than that of banks and other ADIs. APRA’s new powers would be in addition to its March 2017 policy of monitoring the warehouse facilities that banks use to fund non-bank lenders, which gave APRA a level of influence over mortgage underwriting standards in the non-bank market.

As Exhibit 1 shows, the proportion of housing investment loans in RMBS issued by non-bank lenders has increased significantly, accounting for 36% of all mortgages backing non-bank RMBS issued in 2016, up from 16% in 2015. Similarly, interest-only loans accounted for 46% of all mortgages backing RMBS issued by non-bank lenders in 2016, up from 21% in 2015. Overall, non-bank lenders write 6% of total housing loans in Australia.
EXHIBIT 1
Share of Investment and Interest-Only Residential Loans at Non-Bank and Authorised Deposit-Taking Institutions

Notes: Key to previous measures to slow the housing market:
A: Origination, security and stress test guidance and 10% speed limit for housing investment loans.
B: Mortgage risk weight changes.
On 31 March 2017, APRA also introduced a 30% limit for interest-only loans.
* Percent of origination in each quarter based on our rated non-bank RMBS loan-by-loan data.
Sources: Australian Prudential Regulation Authority and Moody’s Investors Service

The extension of APRA’s powers comes as house prices are rising rapidly in some Australian cities such as Sydney and Melbourne. However, property market conditions and risks vary significantly between different regions in Australia, with prices in other regions growing more moderately or even declining.

Empowering APRA to apply different macro-prudential policies to different regions will allow the regulator to introduce measures that specifically target areas where risks are greatest and not affect areas where property market conditions are not deemed a threat. Exhibit 2 shows that house price growth varies significantly among Australian cities.

EXHIBIT 2
House Price Growth among Australian Cities
Australian house prices indexed to 100 as of January 2010.

Source: CoreLogic
**NEWS & ANALYSIS**

**Corporates**
- Coach’s Acquisition of Kate Spade Will Increase Its Leverage
- Greentown’s Proposed Disposal of Commercial Property Assets Is Credit Positive

**Infrastructure**
- Public Service Company of New Mexico’s Proposed Rate Case Settlement Is Credit Positive
- Proposed British Energy Price Cap Would Be Credit Negative for Suppliers

**Banks**
- Georgian Banks Will Benefit from Higher Capital Requirements
- For Macao’s Banks, Further Tightening of Maximum Loan-to-Value Ratio Is Credit Positive
- ORIX’s Investment in Ormat Is Credit Positive

**Insurers**
- Possible Delay in Ruling on MetLife’s SIFI Status Is Credit Negative
- China’s Plans to Tighten Its Regulatory Regime for Insurers Are Credit Positive

**Asset Managers**
- Mexico Fines Four Pension Fund Asset Managers for Anticompetitive Practices, a Credit Negative

**Sub-sovereigns**
- China’s Stricter Regulatory Framework for Regional and Local Government Financial Management Is Credit Positive

**Securitization**
- European Commission Proposal to Include Securitisation Swaps in Margining Rules Is Credit Negative
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