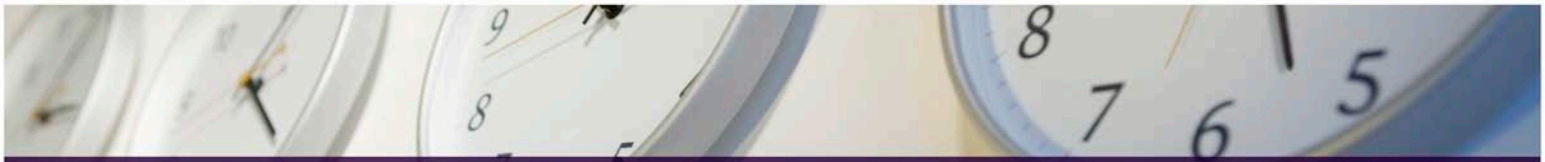

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Qualcomm's Planned Acquisition of NXP Semiconductors Is Credit Negative

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Last Thursday, Qualcomm Incorporated (A1 review for downgrade) said that it had agreed to acquire NXP Semiconductors N.V. (Ba2 review for upgrade), the parent of NXP B.V. (Ba1 review for upgrade), in a transaction with an enterprise value of $47 billion. The acquisition, which Qualcomm expects to close by the end of 2017, is credit negative because it will increase debt and leverage. But we also view the transaction as strategically sound and believe that the combined company's strong free cash flow will allow it to deleverage quickly. Following the deal's announcement, we placed Qualcomm's ratings on review for downgrade and NXP's ratings on review for upgrade.

Qualcomm intends to finance the deal with offshore cash balances and about $11 billion of debt. Upon closing, we estimate that Qualcomm's pro forma gross adjusted debt/EBITDA will rise to about 2.8x from 1.4x at the end of June, while free cash flow/gross debt will fall to about 15% from 29%. The company's cash balances will decline to about $6 billion from $31 billion at the end of June. But Qualcomm and NXP could generate more than $5 billion in combined cash during the regulatory approval process, which will boost liquidity. Given the combined company's strong free cash flow and public commitment to reduce leverage, Qualcomm's gross adjusted debt/EBITDA could approach 2x within two years of closing.

The acquisition is the largest in the history of the semiconductor sector, surpassing Avago Technologies Cayman Finance Ltd.'s (Ba1 positive) $37 billion acquisition of Broadcom Corporation in 2015; Intel Corporation's (A1 stable) $16.7 billion deal to buy Altera Corporation in 2015; and Analog Devices Inc.'s (A3 review for downgrade) pending $14.7 billion purchase of Linear Technology (unrated) this year.

The deal accelerates Qualcomm's diversification into the automotive, industrial and Internet of things (IoT) markets, where chip content is growing, much as it did in computers and communications devices years ago. NXP's $8 billion revenue run rate complements our $2 billion-plus estimated revenue that Qualcomm gets from these faster-growing, non-handset-based markets (out of Qualcomm's $23 billion total revenue). These markets, such as automobiles, home control, industrial automation, wearables and security cameras increasingly require embedded Internet connectivity.

Qualcomm has a leading position in intellectual property licensing to mobile device manufacturers, which is foundational to wireless communications, in addition to applications processors and chipsets. NXP is very well positioned in microcontrollers, sensors and mixed-signal chips targeted at the automotive, industrial and IoT sectors, including the emerging connected-car market, where NXP gets about 40% of its revenue. With Qualcomm's leadership in wireless connectivity chips and NXP's leading position in automotive semiconductors, especially in infotainment, safety systems, networking and secure access, the combined entity will be better positioned to address a fuller set of advanced driver assistance systems and autonomous driving platforms that will be more prevalent over the next decade. We expect regulatory reviews to reach the finish line later in 2017, after which Qualcomm will be off to the races to chase a growing set of opportunities in the car and beyond.

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UPS Order for Boeing B747-8F Freighters Is a Win-Win for Both

On 27 October, United Parcel Service Inc. (UPS A1 stable) announced that it had ordered 14 B747-8F freighters from The Boeing Company (A2 stable). The purchase adds the most efficient large commercial freighter aircraft suited for regularly scheduled operations to UPS' fleet, which will lower costs and improve efficiency in the company's long-haul, freight and package-delivery operations for many years.

Although the aggregate amount of the investment will be material, we believe it will be spread across about 36 months, including the initial pre-delivery deposits. With steady annual free cash flow of about $2.5 billion, UPS has the capacity to pay cash for the aircraft without burdening its liquidity or financial leverage, should it choose to do so. The efficiency benefits that lead to relatively lower operating expenses will provide the return on invested capital UPS requires to make the investment. The order also allows UPS to address the operating risk of declining fuel efficiency and the higher maintenance expense its existing B747-400 fleet will face with each passing year.

The order is also credit positive for Boeing because of its dollar value and boost to the commercial airplane backlog. The order will allow Boeing to extend production of the 747, providing more time to garner other orders from other operators. We estimate that UPS will pay about $140 million on average for each of the 14 firm aircraft, for a total investment of about $2 billion, plus another $150-$200 million for spare engines. This is a significant discount from aircraft appraisers' current-market-value estimates of about $180 million for Boeing's largest freighter delivered new in 2016 and from the list pricing. The firm order has a value of about $5.3 billion at list pricing, and the agreement includes purchase options for 14 more aircraft. However, airlines typically pay about 50% of list prices for aircraft, whether passenger or freighter models, and large customers typically receive further discounts and can also leverage an aircraft program's status when negotiating a purchase.

The B747-8F is a great four-engine aircraft and the latest, and likely last, model of Boeing's storied 747 family that first entered service in 1970. However, the improved power, efficiency and reliability and lower operating and maintenance costs of the engines of large twin-engine, wide-body aircraft have prevented the B747-8 family from achieving commercial success and Boeing realizing the financial returns it estimated when it launched the model.

The global fleet of B747-8Fs stood at about 64 operating and six in backlog across nine operators in September 2016. This compares to 139 Boeing Factory 400s and 39 Boeing conversion freighters, former passenger models that were converted to freighters. Boeing lowered the production rate of the B747-8 family to 0.5 aircraft per month this past September. We believe that UPS leveraged the status of the program to achieve a very good price for the order.

For UPS, we believe that the order will be an incremental capital investment relative to the company's recent annual run rate of about $2.5 billion. We anticipated an increase in annual capital investment since the company's investor day in November 2014, when UPS disclosed that in 2015, as part of its then five-year financial plan, it would be commencing a multi-year period of increased capital investment, which it believed would be funded from higher earnings and operating cash flow.

According to UPS, the new aircraft will displace its existing B747s on its longest and densest routes to gain the greatest benefits of the new model's fuel efficiency and higher capacity. The B747-8F can carry about 16% more cargo than its predecessor, or the same amount of cargo with lower fuel consumption. Maintenance expense per unit of cargo carried will also decline with the maintenance holiday that new aircraft provide during about their first seven years in service. UPS also said that it will move some of its older B747 freighters into domestic service, likely to support the delivery of growing e-commerce orders. Having the larger aircraft in domestic service may also allow UPS to improve the efficiency of its domestic network, helping to manage its cost base.

UPS has 13 B747-400 freighters currently in operation; 11 of the factory model and two Boeing conversion freighters. The converted freighters are less efficient than the factory freighters because they are missing a nose door for loading oversized cargo and their structural strength limits the amount of weight they can carry relative to the factory model.

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Suzano's Purchase of Forest Assets Reduces Costs and Improves Competitiveness

Last Wednesday, Suzano Papel e Celulose S.A. (Ba2 stable) signed an agreement to purchase forest assets in Brazil for $245 million, increasing the competitiveness, wood supply and transportation efficiency at Suzano's Imperatriz pulp facility, which produces 44% of the company's consolidated pulp capacity. The transaction, which is subject to approval by Brazil's antitrust authority CADE, is credit positive for Suzano because it reduces the company's operating costs, capital costs and risk of supply disruptions without jeopardizing its credit metrics. Suzano can pay for the acquisition entirely with cash and cash equivalents on hand, without increasing its leverage metrics.

The acquisition from Companhia Siderúrgica Vale do Pindaré (unrated) and COSIMA – Siderúrgica do Maranhão (unrated) will allow Suzano to meet 85% of the Imperatriz mill's wood supply with its own wood, buying the remainder from other forest producers in the region. The deal includes 75,000 hectares of land in Brazil's Maranhão and Tocantins states, 40,000 hectares of which are arable land and planted forests, adding 9 million cubic meters of wood to Suzano's forest asset base.

Along with the forest assets, Suzano is buying a $14 million hydroelectric plant with 19 megawatts of generation capacity as part of the deal. Although Suzano is already energy self-sufficient and generates 30 megawatts of excess capacity, the new plant increases that surplus for selling power on the open market.

The new forest assets will save Suzano about BRL110 million ($35 million) in annual capital and operating costs over the next 10 years, mainly from reducing the distance to transport wood from forest to mill, cutting leasing expenses and third-party wood purchasing costs, and lowering capital spending to plant its own forests. Currently, Suzano purchases 30% of its wood requirements from third parties on a consolidated basis. Reducing transportation across state lines will reduce taxes while minimizing wood supply disruption risks and enhancing Suzano's competitiveness through cyclical downturns.

Suzano's credit metrics have substantially improved over the past couple of years, supported by enhanced cash flow generation in the pulp segment and expanded market share in paper in Brazil, despite the economic downturn there. Suzano's liquidity has also improved, allowing the company to make small acquisitions while still maintaining an adequate liquidity position without increasing leverage. Suzano had BRL4.2 billion in cash and cash equivalents as of 30 September 2016, so the purchase of these forest assets will not weaken the company's total adjusted 3.3x debt/EBITDA ratio.

Suzano's results weakened slightly in the third quarter of 2016 from the previous quarter, mostly because of the depreciation of the Brazilian real, the local currency, lower pulp prices and weakness in Brazil's paper market. Still, Suzano continues to reduce cash costs and maintain a healthy 35.3% EBITDA margin, down from a record 49.4% in September 2015 amid high pulp prices and a then-weak real. Accordingly, Suzano's cash costs have fallen by 5% to BRL637 per ton in the third quarter of 2016 from a year earlier. The company's new forest asset deal aligns with its BRL475 per ton quarterly cash-cost target by 2021-22.

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Remy's Small French Whisky Acquisition Is Credit Positive

Last Thursday, Remy Cointreau S.A. (Baa3 stable) announced that it had entered into exclusive negotiations to acquire the Domaine des Hautes Glaces, a small French organic producer of whisky with a distillery in the heart of the French Alps. The acquisition, the price of which Remy did not disclose, is credit positive for Remy because we expect strong growth from its products and Domaine des Hautes Glaces' premium products help Remy focus on the ultra-premium category. We also do not expect the acquisition to delay Remy's deleveraging, but do expect it to modestly contribute to Remy's future volumes and revenues.

The acquired assets have strong growth potential given that consumers' appetite for niche whisky is currently high and growth in the sector is higher than the overall spirits sector, whose volumes we expect will grow at a low-single-digit rate. High premium and flavoured whiskies, particularly in the US, are growing strongly with a number of brands growing 10%-30% annually.

We expect Domaine des Hautes Glaces' products to benefit from Remy's larger distribution network and greater marketing capacity. Domaine des Hautes Glaces produces a range of single malt whiskies, including flavoured ones. Despite being a niche player, we expect its strong local heritage and focus on organic ingredients and use of renewable energy as its main energy source to appeal to increasing number of consumers.

We understand that Domaine des Hautes Glaces generated approximately €300,000 in revenues in 2015, which equals less than 1% of Remy's revenues. However, Domaine des Hautes Glaces' position as a premium product (its whiskies cost €65-€150) will help Remy focus on the ultra-premium spirits segments. Remy aims to generate around 60% of its revenues from bottles priced at more than $50 (€46) by the end of the fiscal 2020, which ends 31 March 2020, up from 49% at the end of fiscal 2016. Although sales of premium products tend to be more volatile, greater focus on the higher end of the market should help Remy achieve its 2020 target of improving operating margins toward 8%-20% from 17% at the end of fiscal 2016.

Although Remy did not disclose the acquisition cost, we expect it to be modest and significantly lower than the approximately €64 million cash savings that the company expects to achieve this year following the 83% acceptance rate in September of its script dividend (i.e., a dividend part paid in cash at the option of its shareholders). The acceptance rate was particularly high and exceeded our expectations. Cash savings on the dividend payment will significantly improve the company's key credit metrics, particularly its retained cash flow to net debt, which we expect will increase to the mid-20s range at the end of fiscal 2017 from 15% at end of fiscal 2016. The modest size of the potential Domaine des Hautes Glaces acquisition leads us to expect the company to remain on its deleveraging path.

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Archroma's Extraordinary Dividend Is Credit Negative

Last Wednesday, SK Spice Holding SARL (Archroma) (B2 stable), the ultimate parent of the Archroma Group, announced a plan to incur $200 million of incremental debt to fund an extraordinary dividend to its shareholder, US private equity fund SK Capital Partners. The proposed debt-funded dividend is credit negative because it weakens the company's credit metrics and delays its deleveraging.

The $200 million addition of financial debt will increase adjusted pro-forma gross debt/EBITDA for the 12 months that ended 30 June 2016 to 4.3x, from 3.1x before the transaction. At the same time, we estimate approximately $13 million of additional interest expense per annum from the additional debt, which will weaken the adjusted EBITDA/interest ratio to 3.4x for the 12 months that ended June 2016, from 4.65x without the extraordinary dividend. Pro forma adjusted funds from operations (FFO) and free cash flows (FCF) for the 12 months that ended June 2016 will also decline approximately $13 million, resulting in adjusted pro forma FFO/debt of 14.8% versus 22.7% without the transaction, and pro forma FCF/debt of 0.9% versus 3.7% without the transaction.

The announced dividend reflects a more aggressive financial policy than we originally anticipated because it delays management's original deleveraging plan and almost fully exploits the increased headroom to take on more debt, which Archroma built in the last several quarters by outperforming our expectations for its B2 rating. We had expected Archroma's adjusted gross leverage to decline to approximately 3.5x by fiscal 2016 year end as of 30 September. However, as of June 2016, actual adjusted gross leverage was already 3.1x, well ahead of our expectation, from 4.4x for the 12 months that ended March 2015 and pro forma for the acquisition of BASF Textile business in June 2015. Therefore, the announced extraordinary dividend, which will increase pro forma adjusted gross leverage to 4.3x for the 12 months ending June 2016, will reposition the ratio close to where it was in March 2015.

Although credit negative, the transaction has no rating implications. We affirmed Archroma's B2 corporate family rating on 26 October 2016 after the announcement because we expect that credit metrics will remain commensurate with the current rating and will improve over time. We expect that Archroma will be able to reduce its adjusted gross leverage over the next two to three years toward 3.5x or lower, from 4.3x pro forma for the transaction. Deleveraging will be driven by projected increases in EBITDA and FCF, assuming a broadly stable operating environment for the company's core business and management's ongoing focus on achieving efficiency improvements and cost savings.

Switzerland-based Archroma was set up in September 2013, when SK Capital Partners, the current owner, acquired Clariant AG's (Ba1 negative) textile chemicals, paper solutions and emulsion-products businesses. Archroma has become the largest global supplier of textile chemicals, following its acquisition of BASF's textile chemical business (BASF Textile) in June 2015. Archroma has also a marginal presence in the large paper chemicals industry, with leading positions in selected products, particularly colorants and optical brightening agents, and in the more regional emulsion products industry, in Latin America. In fiscal 2015, Archroma reported consolidated revenues of $1.3 billion. SK Capital Partners, the owner of Archroma, is a mid-sized US-based private equity sponsor with a strong focus on the chemical industry.

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Lenta's Acquisition of Kesko's Russian Grocery Retail Business Is Credit Positive

On Wednesday, Lenta Limited (Ba3 stable) announced that it had agreed to acquire Kesko's (unrated) Russian food retail business for RUB11.0 billion ($177 million). The acquisition is credit positive for Lenta because it will help the company reinforce its leading position in a key market and speed up the expansion of its stores, which should more than compensate for the slight increase in leverage after the deal closes.

Pro forma for the transaction, we expect Lenta's adjusted debt/EBITDA to increase from 3.0x as of the end of June 2016, but not to more than 3.5x over the next 12-18 months, which is within our quantitative leverage guidance for its Ba3 rating. The acquisition comes amid an ambitious capex programme planned for this year, so there are execution risks associated with Lenta's aggressive growth strategy, particularly considering Russia's currently challenging operating conditions. Still, acquiring existing stores is less risky than Lenta developing stores on its own.

Overall, we expect that in 2017 Kesko's 11 stores will contribute more than 3% of the company's total adjusted EBITDA, and that these stores' operating performance will improve to levels comparable with Lenta's stores. Kesko operates 10 hypermarkets and one supermarket under the K-Ruoka brand in St. Petersburg and the Leningrad region.

We expect that Lenta will fund the acquisition with an RUB11 billion cash payment to Kesko, which will be financed using Lenta's cash reserves and available long-term credit facilities. Lenta expects that the transaction, which is subject to approval of Federal Antimonopoly Service of the Russian Federation, will close by the end of November.

The deal will allow Lenta to increase its number of hypermarkets in St. Petersburg and the Leningrad region to 32, which in addition to 10 supermarkets will comprise 186,489 square meters of selling space in the region. The 11 newly acquired stores are favourably located and we do not expect a significant cannibalization of sales at existing Lenta stores in the region.

With an average price of around RUB1.0 billion per store, the deal is fairly attractive for Lenta because this amount is lower than the average capex at Lenta's compact hypermarkets. The stores' existing customer base will make their sales ramp-up faster than for the newly built stores. Furthermore, we expect a substantial improvement in traffic at these stores following the transition to Lenta's format. Kesko's Russian food retail business is focused on imported goods, and its performance has suffered amid a the ruble's depreciation and the Russian government's decision to ban food imports from the European Union (EU) and other countries.

Moreover, as one of the largest hypermarket players in Russia, Lenta has stronger bargaining power with local suppliers than that of smaller peers such as Kesko's Russian food retail business. These factors, along with the focus on low prices and promotions, a strong loyalty program and cost control and supply chain efficiency should allow Lenta to successfully complete a turnaround of these stores in the current challenging operating environment. Indeed, we expect these 11 stores to substantially improve their operating performance and generate incremental EBITDA in excess of RUB1.5 billion in 2017 and more than RUB2.0 billion thereafter.

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GKN's Divestiture of Stromag Subsidiary Is Credit Positive

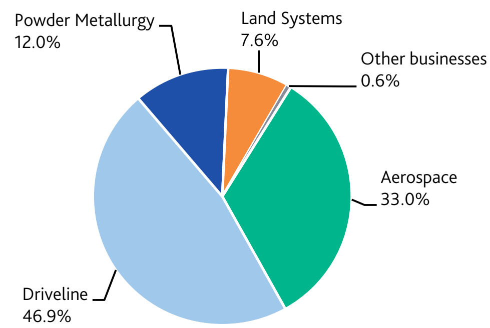
On Friday, 21 October, GKN plc, the parent company of GKN Holdings plc (Baa3 stable), announced that it has agreed to sell its German subsidiary Stromag, part of GKN's Land Systems division, to Altra Industrial Motion Corp. (unrated) for a total consideration of £177 million (including £13 million of debt). GKN expects a cash inflow of £164 million. The sale is credit positive because it will reduce GKN's exposure to the weak agricultural market and enhance its liquidity.

GKN achieved an attractive valuation for Stromag, equal to 1.5x net 2015 sales (£117 million), despite Stromag's recent operating challenges. We expect the sale to also increase GKN's profit margin.

Stromag supplies brakes, clutches and highly flexible couplings to the agricultural, construction, industrial and renewable energy markets. GKN bought Stromag in 2011 with the intention to build its Land Systems division into an important player in industrial power management as well as to grow the division's sales in North America. GKN in the meantime has refocused its business on auto supply and aerospace.

Although the divestiture somewhat decreases GKN's business diversification (the Land Systems revenue share of total group revenues will decrease to 7.6% of 2015 sales from 9.0%) as shown in Exhibit 1, the divestiture should positively affect the group's overall profit margin. Land Systems, which is the company's fourth-largest business segment by revenue, has underperformed in recent years amid a challenging agricultural equipment market, mainly in the US.

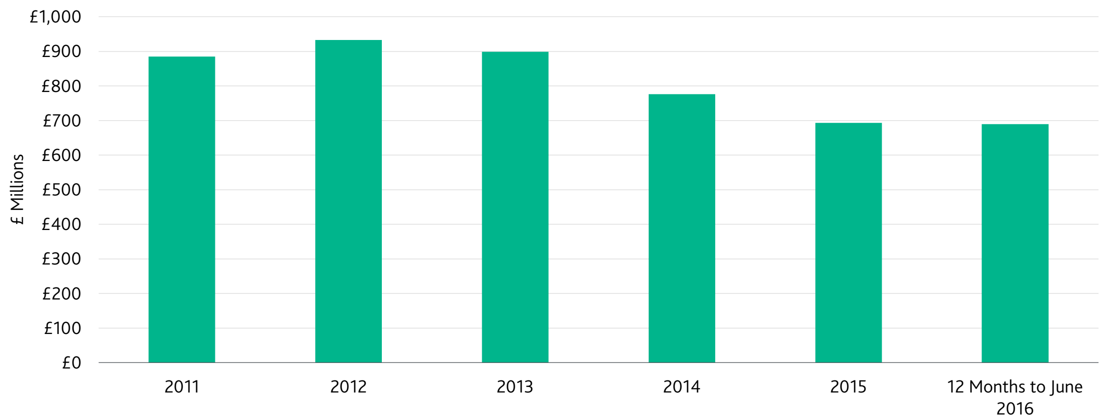
EXHIBIT 1
GKN's Revenue by Business Segment in 2015, Pro Forma for Stromag Divestiture



Sources: GKN disclosures and 2015 Annual Report

Land Systems sales have declined consistently since 2012, as shown in Exhibit 2, and margins have been below those of the group's other divisions, weighing on the overall group performance. However, despite the decline of sales of the Land System division by 6% in first-half 2016, GKN was able to increase the division's reported trading margin by 0.6 percentage points year over year to 4.6% in the first half of 2016, mainly driven by restructuring and cost savings measures.

EXHIBIT 2
GKN Land Division's Net Sales



Sources: Company data and Moody's Financial Metrics

Although the company did not disclose how it will use the cash proceeds, we do not expect a distribution to shareholders. GKN's reported pension obligations increased £543 million in the first half of 2016 because of changes in the discount rates used and adverse currency movements. Therefore, the cash inflow of £164 million, if not reinvested, will enhance GKN's Moody's- adjusted cash-to-debt ratio (including the increased pension liability) to around 12% from 7% for the 12 months that ended June 2016. The effect on GKN's leverage (2.9x as of 30 June 2016), however, should be negligible because of the transaction's relatively small size. The company expects the deal to close in the first quarter of 2017.

GKN plc is a global engineering group. It has four divisions; GKN Aerospace, GKN Driveline, GKN Powder Metallurgy and GKN Land Systems, which operate in the aerospace, automotive and land systems markets. More than 56,000 people work in GKN companies and equity accounted investments in more than 30 countries. GKN is listed on the London Stock Exchange and recorded sales of £7.7 billion in 2015.

Altra Industrial Motion Corp., through its subsidiaries, is a leading global designer, producer and marketer of a wide range of electromechanical power transmission and motion control products. The company has brands covering more than 40 product lines with production facilities in 11 countries. Altra's leading brands include Ameridrives Couplings, Bauer Gear Motor, Bibby Turboflex, Boston Gear, Delroyd Worm Gear, Formsprag Clutch, Guardian Couplings, Huco, Industrial Clutch, Inertia Dynamics, Kilian Manufacturing, Lamiflex Couplings, Marland Clutch, Matrix, Nuttall Gear, Stieber Clutch, Svendborg Brakes, TB Wood's, Twiflex, Warner Electric, Warner Linear, and Wichita Clutch.

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Yestar's Acquisition of Chinese Medical Device Distributor Is Credit Positive

Last Thursday, China-based Yestar International Holdings Company Limited (Ba3 stable) announced that it would acquire 70% of Chinese medical device distributor Shenzhen De Run Li Jia Company Ltd. (unrated) for RMB428 million. The transaction is credit positive because it will expand the footprint of Yestar's high-margin in vitro diagnostic (IVD) product distribution business. The funding is also in place following the company's $200 million bond issuance in September.

The acquisition is in line with Yestar's corporate strategy of increasing its IVD business and deepening its relationship with key supplier Roche Holding AG (A1 stable). Earlier this month, Yestar agreed to acquire a distributor based in Guangzhou, and it enters the Shenzhen area with this latest acquisition.

Similar to its previous acquisitions, Yestar will acquire a 70% equity interest upfront, with the remaining 30% to be acquired only after the target company achieves guaranteed net profit amounts for each of the next three years (2017-19). Such a structure reduces integration risk and helps ensure that the target company will retain its value over at least the next three years. In addition, the target company's selling shareholders have entered non-compete arrangements through 2024.

As the largest distributor of Fujifilm film products in China, Yestar is actively expanding its IVD distribution business. We expect Yestar's IVD revenue to increase to 61% of the company's total by 2018 from 36% as of 2015, with IVD's gross profit contribution rising to 76% of the company's total from 55% over the same period. IVD products have high gross margins of around 30%, compared with 12%-18% for Yestar's other major products.

Renub Research predicts that China's IVD market will grow at an average of 20% a year between 2014 and 2018, and Yestar is one of the largest IVD distributors for Roche, which had a leading 24.2% share of the market in 2015. Roche's market share will likely rise further over the next two years, according to Renub.

Yestar had RMB385 million in cash at the end of June 2016. With an additional RMB1.3 billion in bond proceeds earmarked for acquisitions, capex and general corporate uses, the company will have enough to fund the acquisitions of both Shenzhen De Run Li Jia and the RMB336 million purchase of the Guangzhou distributor.

We continue to expect Yestar's adjusted leverage, as measured by adjusted debt/EBITDA, to increase to 2.7x by the end of 2016 from 1.3x at the end of 2015, as the company prefunds its acquisitions through the bond issuance. Yestar's leverage ratio will start declining in 2017-18 toward 2.5x, driven by increasing cash flows from the IVD business.

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Broadband Improvement Plan Is Credit Negative for Telekom Malaysia Berhad

On 24 October, 61% government-owned Telekom Malaysia Berhad (TMB, A3 stable) announced a broadband improvement plan for 2017 that includes faster broadband for residential customers. The plan is in line with Prime Minister Datuk Seri Najib Razak announcing that the government plans to double broadband speeds and reduce prices by 50% in the next two years to make high-speed broadband more affordable for the average user.

Lower prices and the potential increase in capital expenditure to support this plan are credit negative for TMB because either one may pressure cash flows or raise debt levels in 2017. TMB's adjusted debt/EBITDA was 2.0x at June 2016 and the company expects capex/revenue of around 30%-35% in 2016 (including mobility services investments).

However, the plan's effect on TMB's credit metrics in 2017 and beyond are unclear at this time because the incremental capital expenditure associated with upgrading TMB's broadband speeds is unknown. Moreover, it is unclear whether the government will partner with TMB in any additional funding -- and implementation -- of this initiative.

It also remains to be seen if this initiative will lead to subscriber growth for TMB and if the migration of TMB's customers to higher-value packages will more than offset the effect of the government's proposed 50% price cut on TMB's revenues and cash flows.

Overall, we view this announced 2017 broadband improvement plan as an acceleration of the company's digital transformation program, which has been achieved in part through public-private partnership agreements with the government. Historically, TMB and the government have collaborated on high-profile government-initiated national projects to expand broadband coverage.

For example, High Speed Broad Band (HSBB) Phase 1 and 2 and Sub Urban Broadband (SUBB) projects are set to deploy the access and domestic core networks to deliver an end-to-end broadband network infrastructure and services, as well as increasing coverage for the nation. HSBB Phase 1 is a 10-year project (started in July 2008) to expand broadband penetration in Malaysia. TMB and the government have together invested RM9.2 billion, of which the government invested around RM2.4 billion (26% of total) as a grant to TMB.

The government and TMB will also share the cost of HSBB Phase 2 and SUBB projects, which will require an investment of RM3.4 billion over a 10-year period. Of the total RM1.8 billion HSBB Phase 2 project cost, TMB will invest RM1.3 billion (72%) and the government will invest RM500 million (28%). Meanwhile, TMB will invest RM1.0 billion (63%) for the RM1.6 billion SUBB project and the government will fund the rest over 10 years.

We expect the majority of TMB's investment in these projects to be front-loaded in the initial years and funded, in part, with additional debt. Still, we expect TMB will continue to deliver on its business model and that growth in broadband revenues will continue to outweigh the decline in traditional voice-based results while maintaining leverage in the 2.0x-2.5x range over the next 18 months, even when considering any additional funding requirements for Broadband Improvement Plan for 2017.

Infrastructure

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Xcel Advances Its Renewables Strategy, a Credit Positive

Last Tuesday, Xcel Energy Inc. (A3 stable) announced plans to build four new wind farms in Minnesota and North Dakota totaling 750 megawatts. These projects are part of the company's strategy to increase its portfolio of renewable assets, and its rate base will rise as a result of the $3.5 billion investment. The projects are credit positive for Xcel because as a component of the company's authorized rate base, these renewable power investments will generate around $175 million in net income annually, including an assumed 10% authorized return on equity and a 50% equity layer in the capital structure.

Additionally, the projects will allow Xcel's subsidiaries to meet states' stringent renewable portfolio standards (in both Minnesota and Colorado, renewables are to equal 30% of total sales by 2020), and reduce its reliance on coal-fired power plants. These projects will be built between 2017-21, and constitute almost 20% of the company's total $18 billion of planned capital expenditures for the period.

This announcement follows a 7 September settlement agreement in Colorado with various counterparties to build the 600-megawatt Rush Creek project, the largest wind project in the US, and the 125-mile, 345-kilovolt Pawnee-Daniels Park transmission line project. The four wind projects will help Xcel reach its goal of doubling its renewable assets over the next 15 years. These projects are Freeborn Wind Energy, a 200-megawatt project in Minnesota developed by Invenergy (unrated); Foxtail Wind, a 150-megawatt project in North Dakota developed by NextEra Energy Resources (unrated); and Blazing Star 1 and 2, two 200-megawatt projects in Minnesota developed by Geronimo Energy (unrated).

If these projects are approved by their respective regulatory authorities, Xcel hopes to have the Colorado wind project in service before year-end 2018 and the Minnesota and North Dakota projects in service by 2020. This would allow the company to benefit from savings associated with federal wind power tax credits and reduce debt-financing requirements, a credit positive.

Attaining pre-approvals from state regulatory commissions is also credit positive because it reduces the likelihood of future investment disallowances and enhances the timely recovery of costs from end-users. We do not see all-in rates increasing more than the industry average of 1%-3% per year because reduced fuel costs will offset the increased costs related to the investment.

In addition, the new renewable projects will help Xcel reduce its reliance on coal-fired power plants. The company aims to decrease its carbon emissions in the Upper Midwest by 60% by 2030 from 2005 levels. These initiatives were reflected in Xcel's 2016-30 Integrated Resource Plan (IRP), which the Minnesota Public Utilities Commission (MPUC) approved on 13 October, and which allows Xcel to retire two units at its Sherburne County coal plant. The plant is owned by Xcel's vertically integrated electric utility subsidiary, Northern States Power Company (Minnesota) (A2 stable). Under the IRP, Sherburne's 682-megawatt Unit 2 will retire in 2023, and the 680-megawatt Unit 1 will retire in 2026. In addition, the approved IRP allows for Xcel to procure 1,000 megawatts of wind power by 2019, which opened the door for these just-announced wind projects.

Xcel is the holding company for four vertically integrated utility subsidiaries: Public Service Company of Colorado (A3 stable), Northern States Power Company (Minnesota) (A2 stable), Southwestern Public Service Company (Baa1 stable) and Northern States Power Company (Wisconsin) (A2 stable). These subsidiaries serve 3.5 million electric and 2.0 million natural gas customers in eight states, but mostly in Colorado, Minnesota, Texas and Wisconsin.

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Eletrobrás Will Benefit from Celg D's November Auction

Last Friday, the Brazilian government published an auction notice for Celg Distribuição SA (Celg D, unrated), the 51%-owned subsidiary of Centrais Elétricas Brasileiras SA (Eletrobrás, Ba3 negative). Celg D's 30 November scheduled auction is credit positive for Eletrobrás because the proceeds, which we expect will total BRL900 million, will allow the company to materially improve its cash position. The auction results will be published at the end of December, followed by the auction settlement and signing of the stock purchase agreement by the end of January 2017.

We expect that Eletrobrás will recognize a BRL594 million gain in cash from operations before changes in working capital, equivalent to 22.8% of the company's Moodys-adjusted consolidated 2015 cash from operations pre-working capital. This would help Eletrobrás fund its historically significant capital expenditure program, which has averaged BRL10 billion annually for the past three years and is currently under review by the company, and reduce its borrowing needs.

Eletrobrás tried to sell Celg D last August, but failed to attract investor interest. The Brazilian government has reviewed the auction conditions, including a revision of the minimum price to BRL1.8 billion from BRL2.8 billion, to better reflect the company's current value. The auction of Celg D will set a precedent for both Eletrobrás and the government in their goal to dispose of six additional distribution companies. Distribution companies managed by Eletrobrás have low efficiency levels and are highly leveraged, resulting in recurring losses to the company.

The schedule of Celg D's auction schedule came as Brazil's senate approved provisional measure MP 735. The measure, which awaits President Michel Temer's approval, allows the government to reimburse up to BRL3.5 billion related to certain costs of Eletrobrás' distribution companies until 2017, and provides the legal foundation for the privatization of Eletrobrás' remaining six power distribution companies.

Celg D is an electricity distribution company serving 237 municipalities in the Brazilian center western state of Goiás. In 2015, Celg D distributed 12,040 gigawatt hours, about 2.5% of the country's electricity consumption. Eletrobrás' distribution business is largely composed of small distribution companies in the north and center west portions of Brazil, constituting around 4% of the total energy distributed in the country.

NEWS & ANALYSIS

Credit implications of current events

Banks

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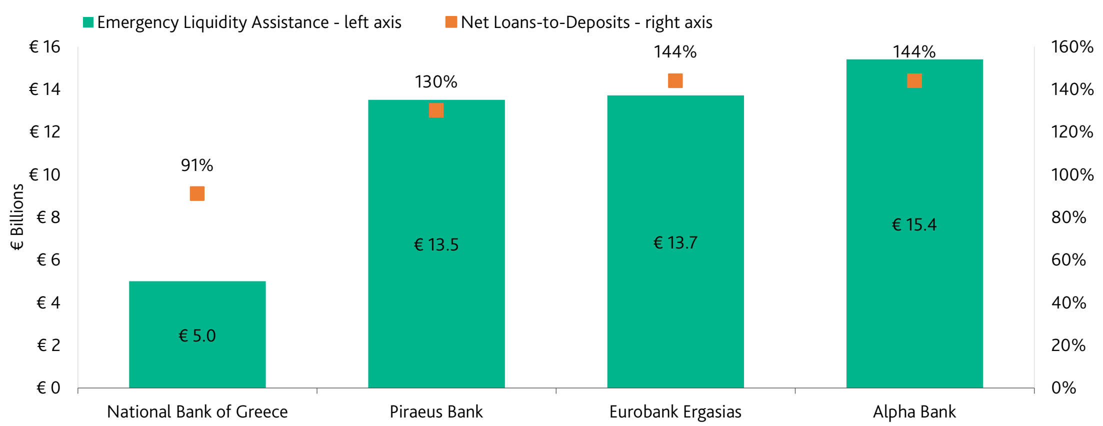
National Bank of Greece's Sale of Astir Palace Vouliagmenis Enhances Liquidity and Capital

Last Thursday, National Bank of Greece S.A. (NBG, Caa3/Caa3 negative, caa3[1]) announced that it had completed the sale of its entire 67.23% stake in the hotel and property resort of Astir Palace Vouliagmenis S.A. to Apollo Investment Holdco SARL for approximately €299 million. The sale is credit positive because it will enhance NBG's liquidity and capital, and further reduce non-banking operations, as per a restructuring plan that will allow management to focus entirely on its core banking operations in Greece.

The sale of Astir Palace Vouliagmenis is part of NBG's restructuring plan, which the bank and the European Commission's Directorate General for Competition (DG Comp) agreed to in connection with NBG receiving state funds for its recapitalisation from the Hellenic Financial Stability Fund (HFSF). The restructuring involves divesting a number of NBG group subsidiaries, including non-banking entities such as the resort, and foreign banking entities such as Finansbank AS (Ba2/Ba1 stable, ba3), which NBG sold in December 2015. DG Comp must ensure that any state funds that NBG receives are dedicated to its Greek banking operations in order to avoid any unfair competition in other industries or in other foreign markets.

NBG will use the sale proceeds to reduce its funding from the Emergency Liquidity Assistance (ELA) mechanism from the Bank of Greece, which is one of the main strategic priorities for all Greek banks. The ELA balance that NBG must repay was around €5 billion in August 2016, or approximately 6% of total assets, the lowest among its local peers (see exhibit). NBG's strong savings deposit franchise and traditionally dominant countrywide branch network and client base underpin its stronger liquidity position, with a domestic net loan/deposit ratio of 91% in June 2016, versus an average of 139% for Greece's other three rated banks.

Greek Banks' Emergency Liquidity Assistance and Domestic Net Loans-to-Deposits



Source: The banks

Disposing of Astir Palace Vouliagmenis will also support NBG's capital base by adding around 46 basis points to its common equity Tier 1 (CET1) ratio. This will bring the bank's phased-in CET1 ratio under the European Union's capital requirements directive (CRD IV) to 22.1% as of June 2016. Its pro forma CET1 ratio excluding its €2 billion contingent capital instruments, which the bank intends to pay back to the HFSF

[1] The bank ratings shown in this report are the bank's deposit rating, senior unsecured debt rating (where available) and baseline credit assessment.

within the next few months, would be 16.8%. Concurrently, the fully loaded CET1 ratio under CRD IV would be 16.2%, which would be at the higher end among its local peers.

Greek banks must have high capital levels in order to contend with an very large stock of problem loans that have been weighing on their balance sheets and credit standing over the past few years. NBG's nonperforming exposures (NPEs) comprised 45.8% of its gross loans as of June 2016, while the provisioning coverage for these NPEs was 54.3%. The bank's net NPEs (NPEs minus cumulative provisions) was around 157% of its CET1 capital, indicating the significant downside risks to its capital base from problem loans.

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3i Group Agrees to Sell Its Debt Management Business to Investcorp for £222 Million, a Credit Positive

Last Tuesday, 3i Group plc (Baa1 stable) announced that it had agreed to sell its Debt Management business to Investcorp S.A. (Ba2 negative) for £222 million, and expects to complete the sale by March 2017. The sale is credit positive and a source of relatively stable fee and portfolio income. With the sale, 3i will book an exceptional profit on disposal of £36 million. Proceeds of the sale will be deployed in 3i's Group's Private Equity and Infrastructure businesses.

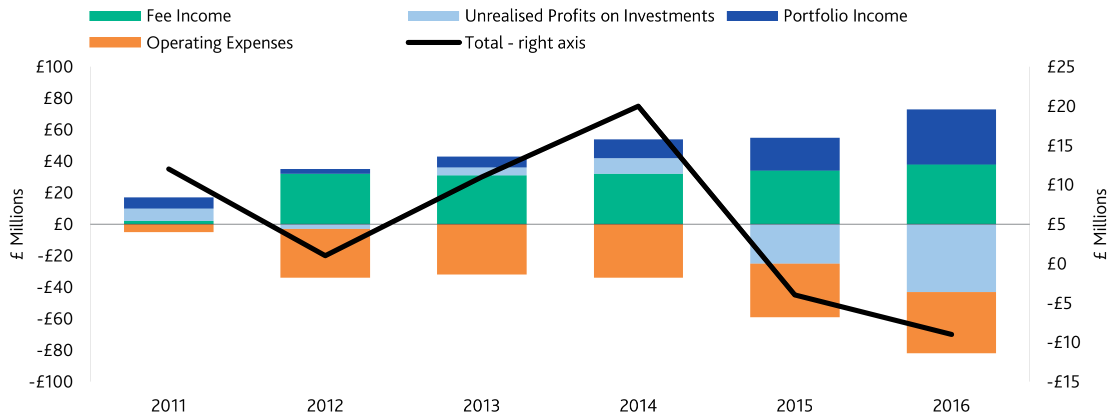
3i's Debt Management business fits less well in its current business than in 2012. The invested capital in the Debt Management business has resulted in mark-to-market volatility on its CLO investments. Under risk retention rules, 3i Group was obliged to invest its own capital in each collateralized loan obligation (CLO) transaction, leaving it with a minimum 5% stake in the European CLOs it managed; and similar requirements come into force in the US starting December 2016.

3i's Debt Management business was formed in February 2011 with the acquisition of Mizuho Investment Management, with additions including WCAS Fraser Sullivan Investment Management and five European CLO management contracts from Invesco. As of 30 September, the Debt Management business had $12 billion of assets under management in Europe and the US. 3i Group will continue to hold certain CLO investments valued at £56 million at 30 September and will maintain its seed investments in its Global Income Fund (£52 million invested) and the Senior Loan Fund (£6 million invested).

Given the regulatory requirements for risk retention (so-called skin in the game) when launching CLO transactions, 3i Group will no longer tie up capital to support the launch of new CLOs, substantially eliminating the resultant volatility in capital. In addition, the sale gives 3i Group management the opportunity to focus on its investments in Private Equity and Infrastructure. 3i Group already has ample liquidity, with cash balances of £1 billion as of 31 March, a portion of which will be used to repay roughly £262 million outstanding on their bond due in March 2017. In addition, 3i Group has a £328.5 million revolving credit facility that was recently extended to September 2021.

Notwithstanding these benefits, 3i Group will lose a business that provided an increasing source of cash income from fees and portfolio income (see Exhibit). The income afforded 3i Group the opportunity to cover operating expenses with cash income without relying on realisations to meet this requirement. It also provided 3i Group with some revenue diversification, although this was limited in practice given that the performance of the Debt Management business is correlated with Private Equity, as both activities invest in corporates.

3i Group's Debt Management Income and Expenses, 2011-16



Note: Years 2011 and 2012 are shown on an IFRS basis; 2012-16 are shown on an investment basis.
Source: 3i Group annual reports

Overall, the transaction is positive because the business will no longer face the interim balance sheet volatility of its capital invested in the Debt Management business. Furthermore, given the firm's track record in Private Equity, we would expect the reallocation of capital to Private Equity to offset some of the lost cash income and to improve overall returns for the firm. Because of the relatively small use of balance sheet for Debt Management (£229 million at 31 March), in comparison with the Private Equity business (£3.7 billion at 31 March), the remaining 3i business will be adequately diversified to support the Baa1 long-term rating.

NEWS & ANALYSIS

Credit implications of current events

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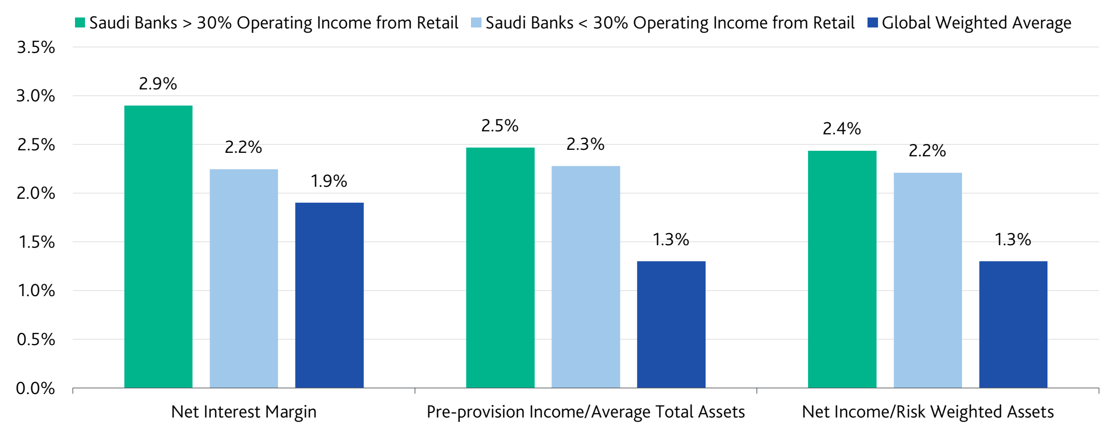
Saudi Central Bank Asks Banks to Reschedule Property Loans, a Credit Negative for Retail Banks

Last Tuesday, the Saudi Arabia (A1 stable) central bank, Saudi Arabia Monetary Agency (SAMA), asked banks to reschedule the property loans of citizens whose disposable incomes were negatively affected by the 26 September cuts in public-sector employees' bonuses, allowances and other financial perks. SAMA further asked banks to maintain existing interest rates without applying any additional fees, a credit negative for banks' profitability, especially large Saudi retail banks.

Given that most Saudi banks' consumer loan portfolios have fixed interest rates, loan rescheduling will be negative for the banks' net interest margins because banks' cost of funding has increased in recent months (three-month SAIBOR was 2.34% on 27 October, compared with 0.9% a year before). In addition, SAMA's request that banks leave interest rates and fees unchanged for rescheduled loans will prevent retail lenders from adjusting their pricing to reflect longer tenors and also the borrowers' declining debt-service capacity.

We expect the loan rescheduling to negatively affect banks' operating profits, although Saudi banking system average profitability metrics have been high, with a 2.7% net interest margin and a 2.4% pre-provision income-to-average-total-assets ratio as of June 2016, which compare well with global averages of 1.9% and 1.3% respectively. The rescheduling will particularly affect Saudi banks with large retail loan portfolios, such as Al Rajhi Bank (A1 stable, a3[2]) and Bank AlBilad (A3stable, baa2), which derive more than 50% of their operating income from the retail segment. These banks' profits so far have been relatively resilient to the weakening economic conditions in Saudi Arabia compared with corporate banking activities. For instance, Saudi banks with more than 30% of their operating income sourced from retail activities had a net interest margin of 2.9% and pre-provision income-to-average total assets ratio of 2.5% as of June 2016, versus 2.2% and 2.3% respectively for other domestic banks.

Saudi Banks' Profitability Metrics, Annualized Income as of First-Half 2016
Saudi banks with large retail franchises have posted stronger profitability metrics than other domestic banks.



Sources: Moody's Investors Service

We estimate that around 66% of Saudi Arabia's employed population of 5 million work in the public sector and that this group is the largest customer segment for retail banking activities in the country. The government's decision to scale back employees' allowances, in response to its material fiscal deficit (15% of GDP in 2015) will negatively affect the borrowers' debt burden ratio (which SAMA capped at 33.33% of the monthly salary plus all fixed allowances), and will in turn increase asset-quality pressures in Saudi banks' consumer lending portfolios. Although the consumer lending segment is only around 32% of banks' credit

2 The ratings shown are the bank's deposit rating and its baseline credit assessment.

(24% for consumer loans and 8% for property loans), it has significantly contributed to the 12% annual loan growth since 2010 with very low levels of reported nonperforming loans (i.e., 0.8% of gross loans as of year-end 2015 versus 1.2% for the banks' total credit exposure).

We expect the cuts in public sector salaries to slow Saudi banks' credit growth in 2017, which we expect at 3%-5%, versus 8.9% year on year as of June 2016. We also expect an increase in problem loans to 2.5% by year-end 2017 versus 1.5% as of June 2016 and further reduction in customer deposits, which contracted 2.8% year on year as of August 2016.

Since the plunge in oil prices in 2014, tighter liquidity, increased cost of funding, reduced trade flows and asset-quality challenges in various sectors such as building and construction have mainly affected corporate banking activities. In contrast, large retail banks have been resilient thanks to granular, stable and low-cost deposit funding and very low asset risks. The loan rescheduling will adversely affect their resilience.

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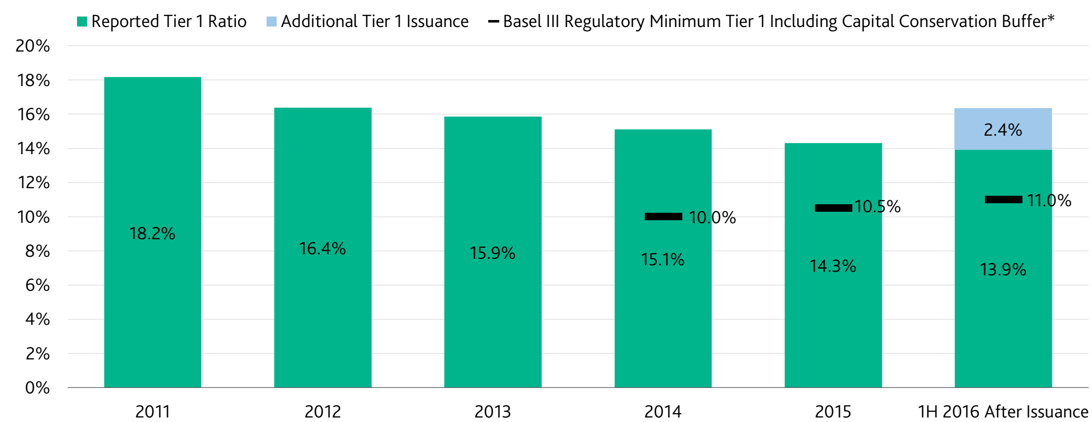
Ahli United Bank's Additional Tier 1 Sukuk Issuance Is Credit Positive

On Tuesday, Kuwait's Ahli United Bank K.S.C.P (A2 stable, baa3[3]) completed a $200 million Additional Tier 1 (AT1) sukuk issuance. The issuance is credit positive because it reverses the decline in Ahli United's capital from financing growth, and supports the bank's liquid resources as low oil prices tighten bank liquidity in the region.

The issuance strengthens Ahli United's regulatory Tier 1 capital, which we estimate at around 16.3% as of June 2016 on a pro forma basis, from a reported 14.3% as of December 2015 (see exhibit). It provides the bank with more headroom against the minimum Tier 1 capital of 11% that the Central Bank of Kuwait will impose at the end of this year as part of its gradual implementation of Basel III capital requirements. This additional capital will also support the bank's financing growth, after low double-digit financings growth (around 13% on a compounded aggregate basis) over 2011-15 drove an increase in risk weighted assets that resulted in the gradual decline in capital metrics.

Ahli United Bank's Tier 1 Capital Ratio



Notes: * Basel III capital requirements in Kuwait were gradually introduced from 2014; Minimum regulatory capital is as of 31 December of each year; first-half 2016 metrics are pro forma.
Sources: Central Bank of Kuwait and Ahli United Bank

Moreover, this issuance will support Ahli United's liquid assets and provide a buffer to potential funding pressure as persistently low oil prices challenges liquidity throughout the region. The bank's liquid banking assets were solid at 27.5% of tangible banking assets as of June 2016, although lower than the local average of around 33%. Ahli United had a 6.6% of market share of the Kuwaiti banking system assets system as of June 2016, with total assets of KWD4.0 billion ($13.1 billion).

[3] The bank ratings shown in this report are the bank's deposit rating and baseline credit assessment.

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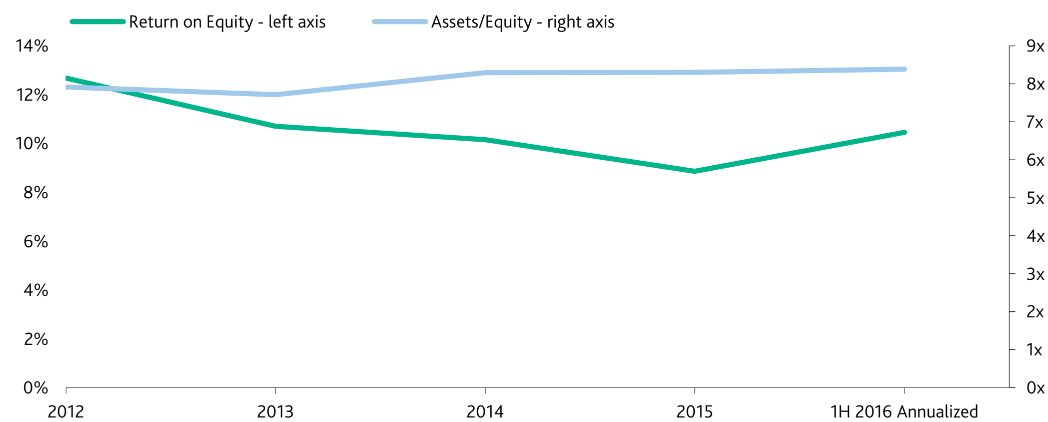
A Bank of China Sale of Chiyu Bank Would Be Credit Negative for Chiyu

On 26 October, Bank of China Limited (BOC, A1 negative, baa2[4]) and Bank of China (Hong Kong) Limited (BOC Hong Kong, Aa3 negative, a2) jointly announced the potential sale of Chiyu Banking Corporation Ltd. (Chiyu Bank, A1 negative, a3). BOC Hong Kong has a 70.5% stake in Chiyu. The announcement said a sale would be consistent with BOC's overall business strategy and enable better allocation of resources. BOC must gain approval from relevant regulatory authorities in Mainland China for the sale, which we think is likely.

The sale would be credit negative for Chiyu Bank because it would likely reduce affiliate support following its possible sale. In our opinion, Chiyu Bank currently benefits from very high parental support from BOC Hong Kong, and a moderate likelihood of indirect support from the Hong Kong government that would flow through BOC Hong Kong. In our view, Chiyu Bank is unlikely to benefit from as much external support from the government or the new owner following its break-up from the group.

We expect the potential sale will also bring downward pressure to Chiyu Bank's standalone credit quality. We expect the bank to increase its balance sheet leverage because a potential buyer would likely seek a higher return on equity than its 10.5% in the first-half of 2016 (see Exhibit 1). Chiyu Bank currently maintains very sound capital adequacy and had a common equity Tier 1 ratio of 16.1% as of 30 June 2016, and low leverage with an asset/equity ratio of 8.4x, both of which compare favorably against most rated peer banks in Hong Kong. The bank's capital adequacy will likely face pressure from higher growth and increased leverage following a sale.

EXHIBIT 1
Chiyu Bank's Return on Equity and Leverage



Sources: Company data and Moody's Banking Financial Metrics

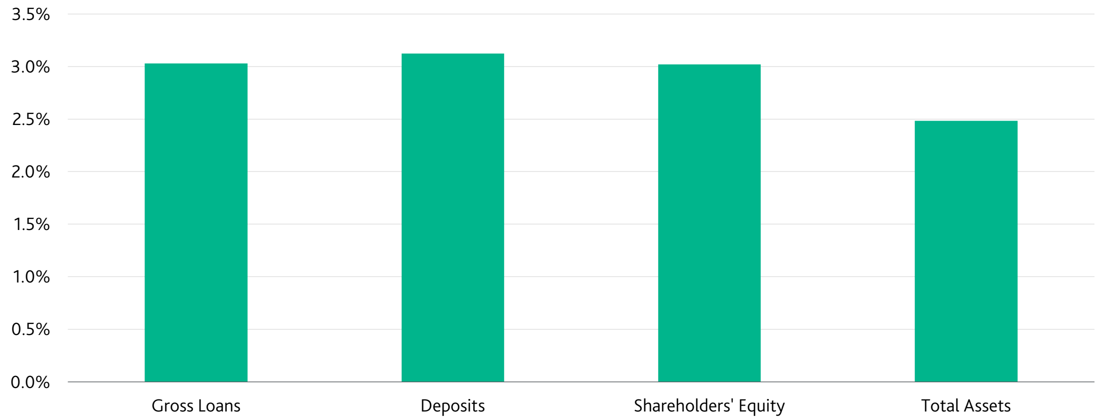
In recent years, Hong Kong banks have been very attractive to buyers, resulting in high book multiples on the acquisitions. Acquisitions of Hong Kong banks by Chinese and overseas buyers since 2014 include Chong Hing Bank Limited (Baa2 stable, baa2), Nanyang Commercial Bank, Ltd. (A3 negative, baa2), and OCBC Wing Hang Bank Limited (Aa3 negative, a3). The acquisition multiples were up to 2x book equity.

Potential gains from the sale of Chiyu Bank and deconsolidation of its assets would be modestly credit positive for BOC Hong Kong. Chiyu Bank's total assets were 2.4% of BOC Hong Kong total assets, and Chiyu Bank's shareholder equity was 3.0% of that of BOC Hong Kong at 30 June 2016 (Exhibit 2). We estimate that potential gains from the sale would at best increase BOC Hong Kong's equity by mid-single-digit percentage points.

4 The bank ratings shown in this report are the banks' deposit rating and baseline credit assessment.

EXHIBIT 2

Chiyu Bank's Loans, Deposits, Shareholder Equity and Total Assets Relative to Those of Bank of China (Hong Kong)



Sources: Company data and Moody's Banking Financial Metrics

Insurers

China Oceanwide's Acquisition of Genworth Would Be Credit Positive

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On 23 October, China Oceanwide Holdings Group Co. Ltd (COH, unrated), announced that affiliates Asia Pacific Global Capital Co., Ltd, and Asia Pacific Global Capital USA Corporation would purchase Genworth Financial Inc., the parent of Genworth Holdings (Ba3 review for downgrade), and its subsidiaries for approximately $2.7 billion in cash. The acquisition would be credit positive and would support Genworth's restructuring plan and improve holding company liquidity.

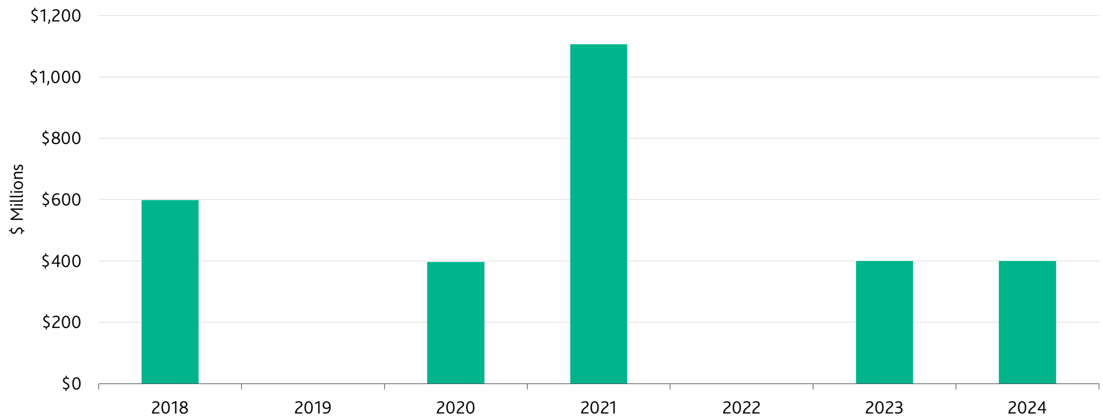
Upon completion of the transaction, which Genworth anticipates will close prior to 31 August 2017, COH expects Genworth Financial to be a standalone subsidiary led by its existing management team. Both companies' boards of directors have approved the transaction, but closing remains subject to certain conditions and approval by Genworth stockholders and various regulatory clearances that include certain US state insurance regulators, US financial industry regulators, the Committee on Foreign Investment in the US, Fannie Mae, Freddie Mac, and regulators in Australia, Canada, New Zealand and China.

The acquisition is timely for Genworth and would help offset the company's recently announced third-quarter 2016 preliminary charge of $400-$450 million pretax related to its long-term-care (LTC) insurance business, and a $275-$325 million non-cash tax charge. These charges and the risk associated with its LTC business and meaningful interest sensitive universal life business are contributing to the underperformance in the company's life insurance companies. The deal will support Genworth's restructuring plan of containing risk in its life insurance business with a $1.1 billion capital infusion and growing its US mortgage insurance business, Genworth Mortgage Insurance Corporation (Ba1 stable); its Australian mortgage insurance business, Genworth Financial Mortgage Insurance Pty Ltd (A3 negative); and its Canadian mortgage insurance business, Genworth MI Canada Inc. (unrated).

In addition to the purchase price to be paid to shareholders, COH has indicated that it will pay down Genworth's $600 million of outstanding debt due in 2018 before or at maturity and contribute $525 million of capital (Genworth will also contribute $175 million of equity) to support Genworth Life Insurance Company (GLIC, Ba2 review for downgrade) and Genworth Life Insurance Company of New York (GLICNY, Ba2 review for downgrade). Genworth expects this support to facilitate the separation and isolation of its LTC business from creditors through an "unstacking," in which GLIC and GLICNY, which contain volatile and underperforming LTC businesses, are separated from Genworth Life and Annuity Insurance Company (Baa2 review for downgrade). COH has made the unstacking a condition to closing the transaction and indicated they will not contribute additional funds to support the legacy LTC block following an unstacking.

Despite the deal's credit-positive implications for Genworth, it faces execution risk associated with the transaction, weak results from its life insurance operations, and the maturity of $1.5 billion of debt in 2020 and 2021, as shown in Exhibit 1.

EXHIBIT 1
Genworth Debt Maturity Schedule Has Substantial Maturities in 2020 and 2021



Sources: Genworth 2015 10k

COH is an international holding company based in Beijing, China with diversified investments across a range of industry sectors, Chinese companies have been active acquirers of insurance companies in the US over the past several months, as shown in Exhibit 2.

EXHIBIT 2
Recent Chinese Insurance M&A Activity

Region of Target	Acquirer and Insurance Financial Strength Rating	Target and Insurance Financial Strength Rating	Announcement Date	Acquisition Price $ Billions
European Union	Anbang, Unrated	VIVAT, Baa3	February-15	$1.9
	China Minsheng, Unrated	SIRIUS, A3	July-15	$2.2
US	Fosun, Ba3*	Ironshore, Baa1	May-15	$1.8
	Anbang Life, Unrated	Fidelity & Guaranty Life, Baa3	November-15	$1.6
	China Oceanwide Holdings Group, Unrated	Genworth, Baa2**	October-16	$2.7
Asia	JD Capital, Unrated	Ageas Insurance Co (Asia), Baa1	August-15	$1.4
	Baotou Huazi, Unrated	Huaxia Life, Unrated	September-15	$4.9
	China Thaihot Group, Unrated	Dah Sing Life, Unrated	June-16	$1.4
			Total	**$17.9**

Notes: * Fosun International Limited long term corporate family rating.

** Genworth Life and Annuity Insurance Company insurance financial strength rating.

Source: Moody's Investors Service

Sovereigns

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Sri Lanka's Reinstated VAT Hike Will Keep IMF Program on Track, a Credit Positive

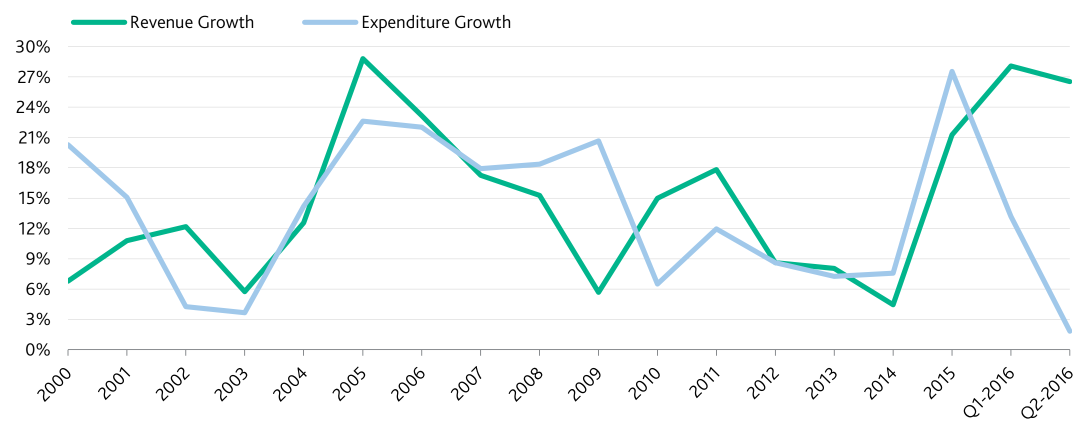
On 26 October, the Sri Lanka (B1 negative) parliament voted in favor of amendments to the value added tax (VAT) bill, which will increase the VAT tax rate to 15% from 11%, paving the way for higher government revenues and adherence to International Monetary Fund (IMF) program commitments. This is credit positive because a higher VAT rate will facilitate fiscal consolidation by strengthening Sri Lanka's low revenue-to-GDP ratio, which is a key credit constraint.

The government originally implemented the VAT hike in May, but retracted it in July after a legal challenge by the main political opposition party in parliament. Backsliding on VAT reform demonstrates the implementation risks surrounding fiscal reforms. Had the implementation delay been prolonged, Sri Lanka would have been at risk of derailing its IMF program and loan disbursements, which would have strained the balance of payments and harmed investor confidence.

The VAT parliamentary vote took place immediately following a Supreme Court ruling that deemed the tax hike permissible under Sri Lankan law. In addition, parliament approved amendments that increase the nation building tax rate on importers, manufactures and service providers to 4% from 2%.

Fiscal consolidation is a major focus of the IMF program with a reduction in the deficit to 5.4% of GDP this year and 3.5% by 2020, from 6.9% in 2015, or 7.4% including one-off expenses. In first-half 2016, government revenues including grants rose a robust 27.3% year on year while expenditures increased 7.1% (Exhibit 1). Revenue growth was broad-based, with increases in VAT, the national building tax and custom duties. As a result, the primary balance, which excludes interest payments, was in deficit of LKR38.6 billion by June 2016, ahead of the IMF program target of LKR46 billion.

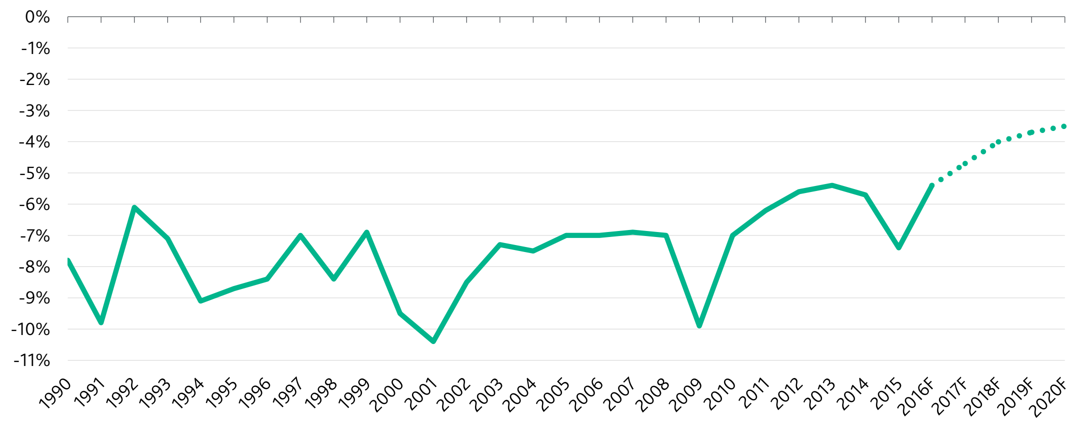
EXHIBIT 1
Sri Lanka's Revenue and Expenditure Growth



Source: Sri Lanka Ministry of Finance

Despite a favorable first half of the year, the primary deficit widened markedly in July. The VAT hiatus makes meeting primary deficit targets challenging, at LKR85 billion for September and LKR97 billion for December. In particular, salary and pension payments accounting for about 36% of primary expenditure and interest payments amounting to around a quarter of total expenditures constrain room to cut expenditures. Longer term, the objective of reducing the deficit to 3.5% of GDP by 2020 is ambitious and would be the smallest deficit in the past 25 years, and indeed in most years since 1950 (Exhibit 2).

EXHIBIT 2
Sri Lanka's Fiscal Balance as a Percent of GDP



Notes: *Fiscal 2016-20 are International Monetary Fund targets.
Source: Central Bank of Sri Lanka

The IMF forecasts an increase in Sri Lanka's revenue-to-GDP ratio to 15.8% by 2020 from 13.0% this year. Reinstating the VAT rate hike is an important step toward achieving the government's revenue objectives, but meeting the IMF or government objectives will involve additional revenue measures. The government aims to broaden the tax base via a new Inland Revenue Act and strengthen revenue collection and administration.

We expect fiscal consolidation to continue, although at a gradual pace, given implementation risks and the country's long track record of poor revenue collection and tax exemptions, which will take several years to change significantly. We forecast a budget deficit of 6.0% of GDP this year and 5.5% in 2017.

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Mozambique Seeks a Credit-Negative Restructuring of Private Sector Debt

On Tuesday, amid rising pressure on Mozambique's (Caa3 negative) domestic and external finances, Finance Minister Adriano Maleiane invited investors to join discussions with the government and its advisors on proposals to restructure a number of debt instruments issued or guaranteed by the government. Mozambique's public debt, of which 81% is external, is on track to reach 130% of GDP by the end of the year. Mozambique has $1.7 billion in private sector debt payments due over the next five years, and only $2 billion in foreign exchange reserves as of August.

However, with obligations to private creditors only 17% of Mozambique's public external debt in nominal terms (or roughly 30% on a present-value basis), restructuring private sector debt alone is likely to only provide limited relief to Mozambique. While unlikely at this juncture, meaningful relief would only be achieved if the restructuring extends to bilateral loans (42% of external debt in nominal terms) as part of a broader restructuring.

The debt instruments the government will consider restructuring are government-guaranteed loans to Mozambique Asset Management (MAM) and Proindicus, as well as the 2023 government bond issued in March 2016 to fulfil the EMATUM notes exchange. The April revelation of previously undisclosed MAM and Proindicus loans totaling $1 billion led us to downgrade Mozambique's Caa1 issuer ratings to Caa3 with a negative outlook in July.

While it is not yet clear how the government proposes restructuring these obligations, a relatively favorable scenario for private creditors would be one in which the MAM and Proindicus loans that amortise from 2016 onwards have their maturities extended and coupons reduced, and the eurobondholders receive lower interest but the same 2023 maturity. Indeed principal payments due under the two loans pose more difficulties for government liquidity in the next five years than the eurobond given that the latter doesn't involve principal payments until maturity in 2023. Mozambique's Caa3 issuer and 2023 eurobond ratings are consistent with likely losses of 20%-35% to private creditors under this scenario.

Although this scenario would likely improve government liquidity for the next five years, the improvement to debt sustainability would be limited. A more credit-negative outcome for bondholders is the government seeking a haircut on the principal of the MAM and Proindicus loans to improve debt sustainability and increase the likelihood of reviving the IMF programme, which was suspended in April after the MAM and Proindicus loans were disclosed. The same approach might well be taken for the government's own eurobond. The negative outlook on the Caa3 rating reflects the possibility that losses under a scenario like this may exceed 35%.

The IMF has not given any indication what amount of debt relief would be necessary for it to remove Mozambique from its debt distress category and resume aid. Nor is there any certainty that creditors would accept the restructuring necessary to meet IMF debt sustainability requirements. The government indicated a desire for a collaborative approach to negotiations and has a January target for any restructuring agreement and implementation, an ambitious objective in our view.

NEWS & ANALYSIS

Credit implications of current events

US Public Finance

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Proposed Affiliation between Catholic Health Initiatives and Dignity Health Would Be Credit Positive

On 24 October, Colorado-based Catholic Health Initiatives (CHI, A3 negative) and California-based Dignity Health (A3 stable) announced that they had signed a non-binding letter of intent to explore plans to join the two organizations. Joining forces would create one of the largest not-for-profit health care systems in the country with expanded market access, greater revenue capture, very strong cash flow diversification, and more efficient capital investment, all credit positive.

The two organizations have a combined pro forma revenue base of more than $25 billion and combined pro forma outstanding debt of almost $15 billion (per the most recent available audits), which would make it the largest organization in our portfolio of rated not-for-profit hospital systems (see Exhibit 1). We would expect the larger size and reach to translate to an enhanced advocacy position, and potentially the more efficient deployment of healthcare resources. Were the affiliation to occur, the combined organization would have operations in over half the states in the country. Although there is some geographical overlap between CHI and certain of Dignity Health's outpatient operations (namely its occupation health enterprise), there is no geographical overlap between CHI and Dignity Health's acute-care facilities, which form the core of both organizations' operations.

EXHIBIT 1

Rated Multistate Healthcare Systems Ranked by Size

CHI and Dignity Health's affiliation will create the largest rated not-for-profit health system in the country.

	Multistate Healthcare System by Revenue	Rating	Outlook	Fiscal Year End	Operating Revenue $ Billion	Direct Debt $ Billion
1	Ascension Health	Aa2	Stable	6/30/16	$21.90	$6.92
2	Providence St. Joseph Health* (Proforma)	Aa3	Stable	12/31/2015	$20.80	$6.51
3	Catholic Health Initiatives	A3	Negative	6/30/15	$15.20	$8.82
4	Trinity Health Credit Group	Aa3	Stable	6/30/15	$14.29	$5.32
5	University of Pittsburgh Medical Center	Aa3	Negative	6/30/16	$12.82	$3.07
6	Dignity Health	A3	Stable	6/30/16	$12.64	$5.48
7	Partners Healthcare System	Aa3	Stable	9/30/15	$11.65	$4.30
8	Sutter Health	Aa3	Stable	12/31/15	$10.62	$3.66
9	Mayo Clinic	Aa2	Stable	12/31/15	$9.98	$2.88
10	Adventist Health System/Sunbelt Obligated Group	Aa2	Stable	12/31/15	$9.12	$3.06

Note: * Formed on 1 July 2016.

Sources: Company data and Moody's Investors Service

CHI, with $15.2 billion of revenues in fiscal 2015, ending 30 June, is currently the third-largest organization in our portfolio of rated not-for-profit hospitals (see Exhibit 2). CHI is headquartered in Englewood, Colorado and has its largest operations in Kentucky, Nebraska, Washington, Colorado, Texas, Ohio and Iowa. Altogether, CHI operates in 18 states, has more than 100 hospitals and employs more than 4,000 physicians.

EXHIBIT 2
Key Indicators for CHI and Dignity Health

	Catholic Health Initiatives 30 June 2015	Dignity Health 30 June 2016	Combined
Long-Term Rating	A3	A3	
Total Revenues $ Billions	$15.20	$12.64	$27.84
Unrestricted Cash and Investments $ Billions	$6.88	$4.88	$11.76
Total Long-Term and Short-Term Debt $ Billions	$8.81	$5.48	$14.29
Cash to Debt	78.1%	89.1%	82.3%
Debt to Revenue	58.0%	43.4%	51.3%

Sources: Company reports and Moody's Investors Service

Dignity Health is headquartered in San Francisco and operates acute-care facilities in California, Nevada and Arizona. Dignity Health's total revenues in fiscal 2016 were $12.6 billion, making it the sixth largest not-for-profit health system in Moody's portfolio. In addition to its acute-care facilities, Dignity Health operates a large network of occupational health centers (US HealthWorks, active in 19 additional states), participates in a large number of health-care related joint ventures, and controls an extensive network of primary care clinics, ambulatory centers, and home health services.

The earliest that a definitive agreement would be reached is early-2017. Both organizations have grown through affiliations over the years, and have experience integrating disparate cultures and operating entities into a single uniform operating platform. Also, both systems include Catholic affiliates, and they share certain Catholic sponsors. Nevertheless, both organizations have recently experienced declining operating measures, with credit deterioration over the past decade, and both are likely to continue to face financial headwinds, be it separately or together. Also, the newly created system would face a number of integration challenges given its broad geographic scale. Nevertheless, we would expect the long-term benefits of affiliation to be credit positive.

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Houston's Proposed Pension Reform Would Reduce Liabilities and Cap Future Costs

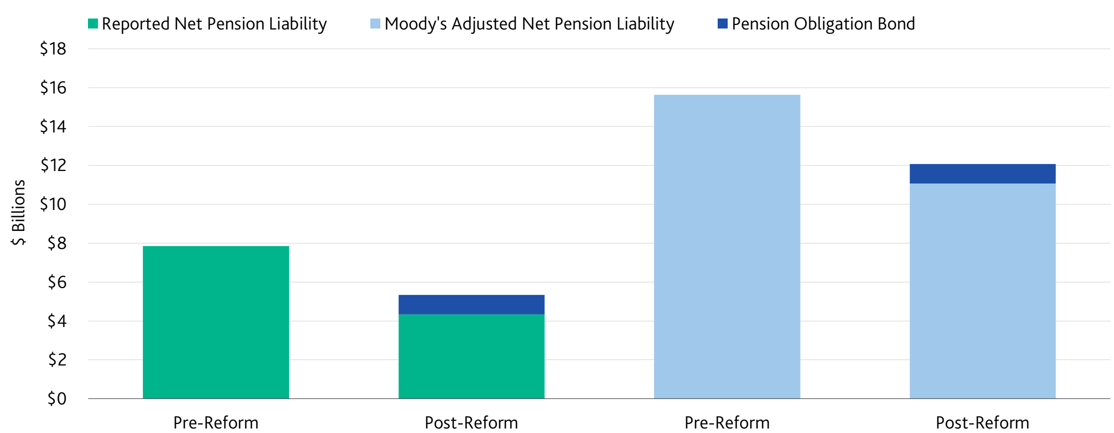
On 26 October, the Houston, Texas (Aa3 negative) City Council voted to accept the mayor's pension reform proposal, following months of negotiations and approval by the city's three pension systems. The plan still requires the state legislature's approval to take effect. The city council's approval increases the likelihood that the credit-positive pension reform proposal will be implemented. The reform would reduce Houston's substantial pension liabilities through benefit changes and would cap the city's future contribution rates.

Houston's unfunded pension liabilities have increased dramatically over the past decade. Reflecting the city's recently revised assumptions, its estimated unfunded liabilities were $7.8 billion as of June 2016, compared with $2.3 billion ten years earlier. Contributions were historically based on "Meet and Confer" agreements for two of the city's three pension plans. However, these contributions often fell below actuarial plan funding requirements, helping to drive growth in unfunded liabilities.

If approved by the state, the benefit reforms would reduce net liabilities across the city's three pension plans by $2.5 billion using reported assumptions, or approximately 32%. The city's plan includes changes to a number of benefit provisions, such as cost-of-living adjustments (COLAs), and also calls for the city to issue $1 billion in pension obligation bonds to bolster plan assets. Inclusive of the bond issuance, net pension liabilities on a reported basis would decline $3.5 billion, to $4.3 billion.

We adjust state and local government pension information to reflect the use of a market-based discount rate, rather than the assumed rate of investment return on plan assets. Based on the city's estimates and inclusive of proposed pension bond assets, we expect its Moody's-adjusted net pension liability (ANPL) as of June 2016 would decline to $11.1 billion from $15.6 billion, while its debt will increase by $1 billion from the pension bonds (see exhibit).

Effect of Proposed Reforms on Houston's Unfunded Pension Obligations under Reported Assumptions and Moody's Adjustments



Sources: City of Houston and Moody's Investors Service

The issuance of pension bonds carries additional budget risk for the city in the event that plan investment returns do not outperform the city's interest cost on the debt. The city would retain full responsibility for paying off the pension bonds and the unfunded liabilities in place as of June 2016. However, the city would also mitigate its budgetary exposure by sharing risk with employees. If the city's costs to amortize newly generated unfunded liabilities exceed specified contribution caps, the package establishes a number of actions, including higher employee contributions and further benefit reductions to bring the city's costs within the caps.

Houston would also increase its contributions in order to amortize unfunded liabilities over 30 years, an improvement over the city's historical levels. Nonetheless, we project that even if the city's pension funds meet 7% annual investment return targets, its unfunded pension obligations would continue growing for approximately seven more years because of the back-loaded payment structure of principal under the expected amortization schedule. This approach would not fully amortize the annual interest on the city's unfunded liabilities, which underscores the substantial pension challenge still facing Houston, even if its reforms are fully implemented.

Pensions are one of Houston's most significant credit challenges. Although the city's economy is exposed to depressed oil prices, its economic performance has benefited from growth in non-energy sectors including downstream petrochemical activity and healthcare. Its property tax base continues to grow and its financial reserve levels have remained consistently healthy in recent years.

Securitization

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German Proposal for Tighter Mortgage Market Rules Is Credit Positive for Pfandbriefe and RMBS

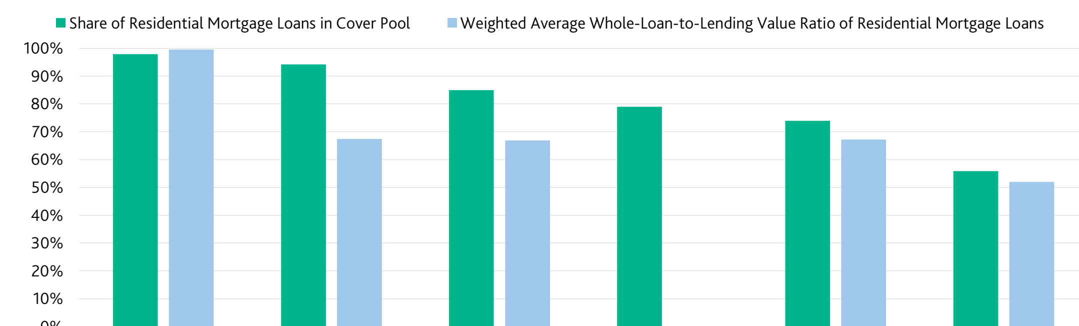
Last Tuesday, German stock exchange gazette Börsen-Zeitung reported that Germany's Ministry of Finance had proposed a draft law aimed at tightening residential mortgage lending market regulations. Once enacted, German Financial Services Authority BaFin would be authorised to tighten residential mortgage loan origination criteria to prevent house prices from overheating. This would be credit positive for mortgage Pfandbriefe (covered bonds) and residential mortgage-backed securities (RMBS) because it would reduce the risk of households taking on excessive debt during times of inflated house prices.

The proposal comprises four components: a maximum loan-to-value (LTV) ratio, a minimum loan amortisation requirement, a maximum debt-service-to-income (DSTI) ratio and a maximum debt-to-income (DTI) ratio. The finance ministry's proposal follows the German Financial Stability Committee's 2015 recommendation to the German government to develop instruments to regulate residential mortgage loan origination.

The government's proposal would only affect newly originated residential mortgage loans because of a grandfathering rule. Therefore, the credit strength of covered bond programmes and RMBS would improve over time, particularly by reducing borrower default, where a maximum LTV ratio will fall below currently LTV ratios.

Exhibit 1 provides an overview of Moody's-rated German mortgage Pfandbriefe in which the residential mortgage loan portion exceeded 50% of total cover pool assets as of 30 June 2016. Covered bondholders of ING DiBa's mortgage Pfandbriefe would benefit the most from a maximum LTV ratio because its cover pool has the highest share of residential mortgage cover assets (97.9%) and the highest weighted average whole-loan-to-lending-value[5] ratio (99.6%). Based on lending values, 32.2% of ING DiBa's residential mortgage cover assets have a whole-loan-to-value ratio above 100%.

EXHIBIT 1
Moody's-Rated German Mortgage Pfandbriefe with the Highest Share of Residential Mortgage Loans as of 30 June 2016



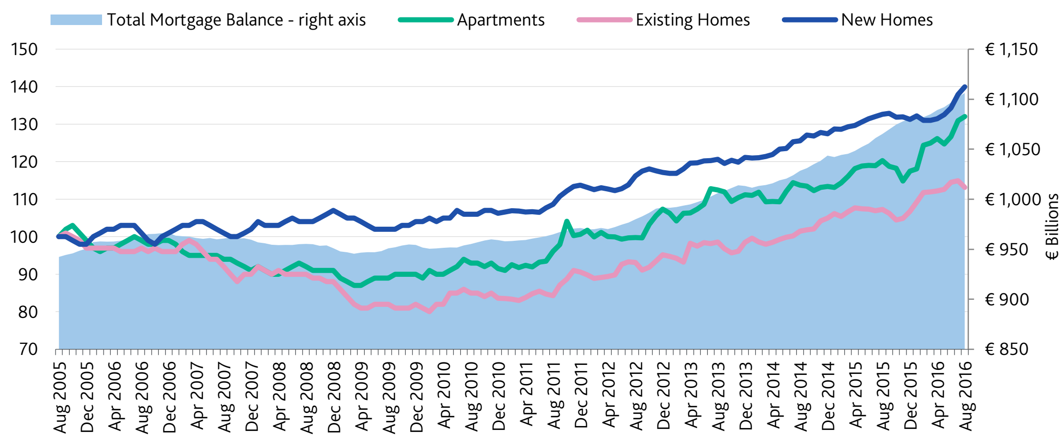
	ING DiBa	Commerzbank	Deutsche Bank	Kreissparkasse Koeln	Sparkasse KoelnBonn	Muenchener Hyp
Share of Residential Mortgage Loans in Cover Pool	97.9%	94.2%	85.0%	79.0%	73.9%	55.9%
Weighted Average Whole-Loan-to-Lending Value Ratio of Residential Mortgage Loans	99.6%	67.4%	66.9%	n/d	67.2%	52.0%

Source: Moody's Investors Service:

[5] The Pfandbrief framework defines the lending value as the long-term sustainable property value excluding speculative price components.

The whole-loan-to-value ratio is not only an important driver of the probability of borrower loan defaults, but also of recoveries following a borrower's default. If the BaFin were to set the maximum loan-to-lending value ratio above 60%, Pfandbriefe would not benefit from improved recoveries following borrower default. This is because under the Pfandbrief Act covered bonds may only be issued against loans backed by up to 60% of the property's lending value. However, the Pfandbrief Act does not limit how much borrowers can borrow against a property. The same applies to the typical eligibility criteria of an RMBS transaction. Therefore, and because lending to residential borrowers has steadily increased since 2010 (see Exhibit 2), a maximum DTI ratio would be credit positive for mortgage Pfandbriefe and German RMBS. This is particularly applicable in the current low interest rate environment, where borrowers' affordability for large loans has substantially improved.

EXHIBIT 2
German Home Loan Mortgage Volume and House-Price Development



Note: House prices are indexed to 100 at August 2005.
Sources: Deutsche Bundesbank and The Hypoport Group

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Volkswagen's Diesel-Emissions Settlement Is Credit Positive for Its US Auto ABS

On Tuesday, Volkswagen Aktiengesellschaft (VW, A3 negative) received final approval from a US federal court for a $14.7 billion settlement that will result in the automaker offering to buy back, terminate leases or repair about 475,000 vehicles affected by its diesel-emissions scandal. The settlement is credit positive for the outstanding US auto lease asset-backed securities (ABS) transaction issued by VW's indirect subsidiary, VW Credit, Inc. (VCI, A3 negative), because the early lease terminations will increase prepayments to the securitization trust, building credit enhancement in the deal, and will allow the trust to reduce residual value risk in a portion of the collateral pool with exposure to the affected vehicles.

In VW's US auto loan ABS transactions, the settlement will also increase prepayments as well as reduce default risk resulting from customer dissatisfaction with the vehicles. Finally, VW's US dealer floorplan ABS transaction will benefit if car owners who sell affected vehicles back to VW via its dealerships then buy replacements from those dealers.

The settlement, approved by Judge Charles Breyer of the US District Court for the Northern District of California, resolves much of the uncertainty over whether VW will compensate customers in the US who bought or leased diesel-powered cars that the automaker had equipped with devices designed to evade emissions-testing standards. Under the settlement, VW will complete the buybacks within 90 days of eligible owners' acceptance of its offer and scheduling an appointment, and will complete the lease terminations within 45 days of offer acceptance by eligible lessees and scheduling an appointment. The agreement covers Volkswagen and Audi vehicles with 2.0-liter diesel engines from model years 2009-15. However, it excludes roughly 80,000 3.0-liter diesel models, which means that the VW ABS transactions will have continued credit risk related to compensation issues for owners of those vehicles.

According to VW, less than 1% of the settlement class has opted out of the agreement, and to date, approximately 340,000 registrations have been created on the settlement website. As a result of the court approval, these customers can now begin to notify VW of their desire to sell back their cars or terminate leases. We expect that a flurry of consumers will return vehicles financed via VCI loans and leases, with only a small minority choosing to have the vehicles fixed, especially considering the lack of government approval for VW's proposed fix.

The repurchases and lease terminations will lead to the retirement of some loan and lease financing in VW ABS ahead of its scheduled maturity and accelerate cash flows to the securitizations. The prepayments will benefit both the loan and lease securitizations by deleveraging the transactions, which have sequential-pay structures with non-declining credit enhancement that grows as a percentage of the deals' pool balance as the transactions pay down. Thus, retiring the loans and leases ahead of schedule will build credit enhancement in the transactions faster, increasing the buffers against collateral losses.

The VW auto lease ABS trust will also benefit from residual value gains as a result of the early lease terminations. When the affected consumers turn in their vehicles early, the trust will receive the remaining payments due, less the remaining effective interest due plus the contract residual from VW. Because securitized residual value amounts tend to be lower than contract residuals, the trust will realize residual value gains.

As a result of the settlement, VW's loan ABS will have a slightly lower risk of elevated default rates tied to customer dissatisfaction stemming from the emissions issues. However, the transactions already had a low risk of rising loan defaults, because recalls historically have not been a defense against loan repayment and because the prime borrowers with financing contracts backing the transactions would damage their credit scores if they defaulted.

VW's floorplan ABS transaction could benefit if consumers return their vehicles to VW dealerships and replace them with new cars from those dealers. If customers buy a new vehicle from a dealer whose inventory is financed via VCI's floorplan trust, the increased sales will boost payment rates for the securitization if dealers do not overestimate demand. Higher payment rates in the floorplan trust will reflect a stronger dealership base and allow for a faster accumulation of funds to pay down the transaction's notes upon maturity.

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