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Prospects for Avon Products Inc. remain uncertain despite turnaround plan

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Avon Products Inc. (Avon), once a member of S&P 500, is one of the world's biggest direct sellers of cosmetics. With about 6mn representatives operating in over 100 countries worldwide, Avon reaches customers largely through door-to-door visits. From 2012 to 2015, the 130-year old company failed to generate positive revenue growth for five consecutive years and the stock price of the company continued to slide. To turn the tide, Avon started a three-year transformation program in January 2016. As part of the program, Avon undertook a few major restructuring efforts subsequently, including selling off its underperforming North American business and receiving USD 650mn. However, a significant improvement from the turnaround plan has yet to be seen at the end of 2017.

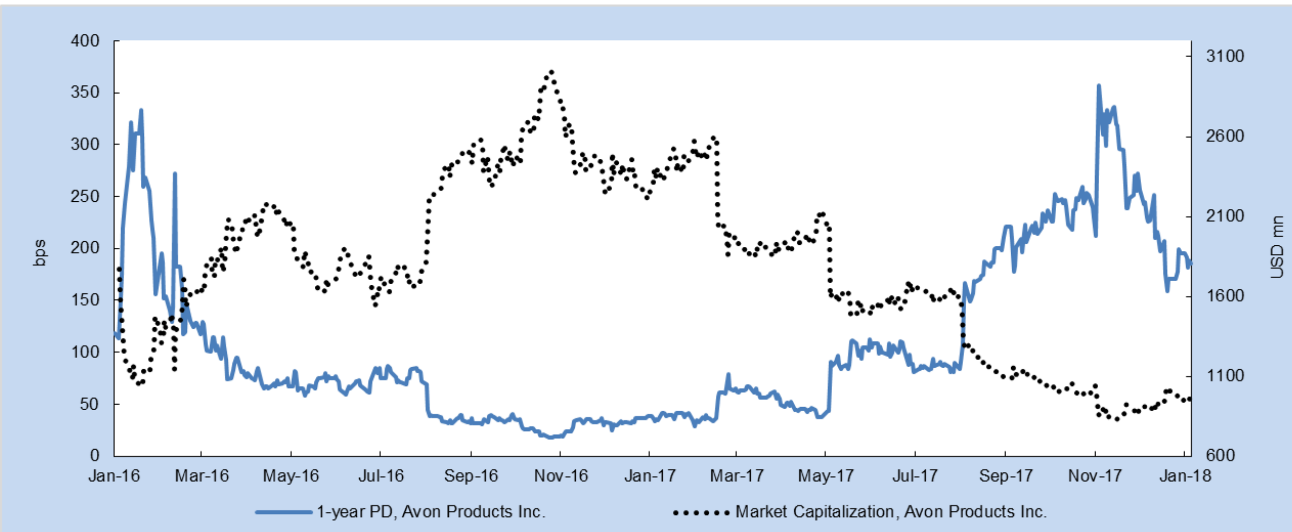

Figure 1: RMI-CRI 1-year PD for Avon (LHS) & Market Capitalization for Avon (RHS) *Source: RMI-CRI, Bloomberg*

In 2017, Avon started to report a series of disappointing financial results. Sales decreased for four consecutive quarters. During the third quarter, EBIT decreased from USD 112mn to USD 83mn and the net income margin decreased from 2.6% to 0.9% compared to a year ago (see Table1). Correspondingly, Avon's market capitalization plunged 59% from USD 2.73bn to below USD 853.60mn and RMI-CRI 1-year Probability of Default (PD) for Avon increased from 20.79bps to 357.09bps in the same period (see Figure 1).

	Q3 2016	Q3 2017
EBIT (USD mn)	112.0	83.0
Net Income Margin (%)	2.6	0.9
EBIT/Interest Expense (X)	3.3	2.4
Net Debt/Capital (%)	130.6	139.6

Table 1: Financial Data for Avon Products Inc. *Source: Bloomberg*

Avon's deteriorating financial performance is caused by its declining pool of active sales representatives, supply chain mismanagement, and coming late to e-commerce. With the current commission structure of Avon, it is harder for its representatives to earn money than its competitors, causing the company to lose representatives for several quarters and to see a decline in average order volume. The failure to manage supply chain well also adds woes to the company. Representatives even have difficulty collecting inventory on time in some countries. What's more, Avon only develops its e-commerce business in recent years. Although effort has somewhat paid off by unveiling a solid functional web with easier tools for tracking sales, it didn't really bridge the gap with rivals' well developed sites.

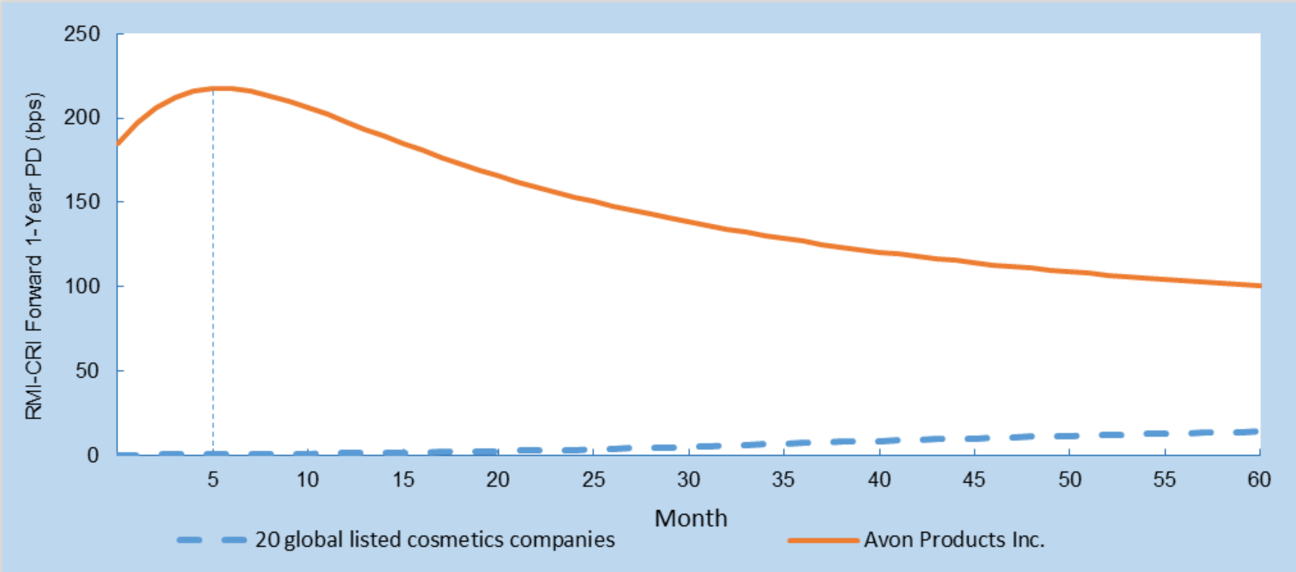

Figure 2: Term structure of RMI-CRI Forward 1-year PD of Avon Products Inc and Aggregate Forward 1-year PD for 20 listed global cosmetics companies on Jan 5, 2018. *Source: RMI-CRI*

The Forward PD term structure of Avon steepens with time to peak at 5 months then decreases, suggesting that based on the market information available as of January 5, 2018, Avon's probability of default is likely to increase in the short term but improve after about a year's time. Intuitively, the Forward PD computes the credit risk of the firm on a future period, which works like a forward interest rate. For instance, the 3-month Forward 1-Year PD is the probability that the firm defaults during the period from 3 months onwards to 1 year plus 3 months, conditional on the firm surviving the next 3 months. The Forward PD trend of Avon coincided with its business uncertainty peaking in 2018, the final year before Avon's 3-year turnaround plan is completed. If Avon can recover well in the year to come, its credit profile is expected to gradually improve.

	Avon	Elf Beauty	Estee Lauder	Inter Parfums	Coty	Revlon
EBITDA Margin (%)	7.89	18.52	21.23	21.15	8.82	4.86
EBITDA/Interest (X)	3.22	5.88	22.42	72.44	2.89	0.84
Total Debts to Total Capital (%)	122.54	49.98	45.29	10.44	43.67	131.58

Table 2: Financial data of Avon and some of its competitors for quarter ending as of 09/30/2017 Source: Bloomberg

However, it is noteworthy that the Forward PD of Avon was higher than the aggregate Forward PD for 20 competitors in the cosmetics industry with market capitalization over USD 1bn, a fact that corresponds to Avon's higher leverage and lower profitability than peers (see Table 2). To catch up with its competitors, Avon still has a long way to go.

Credit News

China's foreign reserves extend rising streak amid capital curbs

Jan 7. China's foreign exchange reserves saw an 11th straight monthly increase with the reserves increasing by USD 20.7bn to reach USD 3.14tn in December. This brought the full-year increase for 2017 to USD 129bn, rebounding from January when the figure fell below USD 3tn for the first time in six years. A major contributor to the rise is the effective implementation of capital controls, which significantly reduced the volume of external flows. However, should the US dollar continue to weaken, China's central bank may seek to relax some of its capital controls. (Bloomberg)

Another retail bankruptcy wave is on the way, Credit Suisse says

Jan 5. As the industry deteriorates faster than expected a year ago, a wave of store closings and retailer bankruptcies is coming in early 2018, according to Credit Suisse Group AG. Even the just-ended Christmas shopping season performed best for retailers in a decade, mall staples like JC Penny Co. did not give pleasant results and Macy's is going to close 11 stores in early 2018. Portions of CMBX 6 and CMBX 7, two commercial mortgage bond indexes, may fall further in 2018. The junk-rated portion of CMBX 6 dropped about 12% in 2017. As fewer commercial mortgages to retailers are bundled into securities, pricing has become more opaque for mid- and low-tier mall and this is a risk to CMBS investors. A detailed understanding of the seismic shifts in the industry is mandatory for CMBS market participants, as noted by analysts. (Bloomberg)

Global debt hits record USD 233tn

Jan 5. Global debt rose to a record USD 233tn in Q3 2017, more than USD 16tn higher from end-2016, according to an analysis by the Institute of International Finance (IIF). Debt in private non-financial sector hit all-time highs in Canada, France, Hong Kong, South Korea, Switzerland and Turkey. Meanwhile, according to IIF, the ratio of debt-to-gross domestic product is 318% now, decreasing for the fourth consecutive quarter as economic growth accelerated. The global population is 7.6bn calculated by the United Nations, suggesting the world's per capita debt is more than USD 30,000. The IIF analysts said that the debt pile could end up acting as a brake on central banks trying to raise interest rates. (Bloomberg)

China property bonds seen facing highest default risk in 2018

Jan 4. China property bonds carry the biggest risk of default in the nation's domestic debt market especially with the policy risks that developers face due to housing cooling measures. The likelihood of default is also higher amongst small regional developers. Yet, the property sector could still be a potential "gold mine" if investors are able to discover undervalued bonds. A record RMB 702bn of domestic bond sales were scrapped in 2017, leading to a decade-low net corporate issuance figure. The number of defaults is expected to increase slightly in 2018, as more market risks surface. (Bloomberg)

UK banks and companies tap debt at fastest rate in 8 years

Jan 4. UK banks and businesses are tapping debt markets at the fastest rate since 2009, and bankers expect the rush to continue this quarter. In November, 2017, the net new issuance of bonds and commercial paper reached GBP 17.5bn among which about three-quarters came from banks and other financial institutions. In the 12 months to November, UK banks and companies raise a net GBP 50bn, which is the highest annual level since 2010. The uptick was heavily concentrated in the bond markets with a net new issuance of GBP 35bn. A banker at JP Morgan expected the trend to continue as banks need to refinance existing debt and stock up on additional capital before 2022 deadline to meet new regulatory requirements. While UK investors still command good market access despite the loss of their premium due to Brexit uncertainty, there is still going to be a great deal of headline risk. (FT)

SunEdison officially emerges from Chapter 11 restructuring (Solar Industry)

Fitch downgrades Wanda Commercial to junk on offshore funding concerns (Nasdaq)

Radio Broadcaster Pacifica Teeters on edge of bankruptcy (WSJ)

Regulatory Updates

Europe begins countdown to Mifid II

Jan 2. January 3 marks a defining moment in financial regulation, the much anticipated introduction of Mifid II, which is designed to offer greater protection for investors and inject more competition into the trading of all asset classes. One of the biggest changes requires asset managers to unbundle the cost of investment research from that of executing trades with banks and brokers, aiming to reduce the potential for conflicts of interest. In fact, Mifid II is more ambitious in that it not only updates existing rules to keep up with technological developments, but also seeks to tackle "the under-regulated and opaque aspects of the financial system", including the vast markets for derivatives and bonds. However, many firms and member states are not fully ready for implementation. (FT)

Brussels looks at easing bank capital rules to spur green investment

Jan 2. Brussels is set to ease capital charges on banks' green investments as the EU seeks to narrow the EUR 180bn annual gap in the financing needed to ward off potentially catastrophic climate change. The vice president of the European Commission in charge of financial regulation also supported the plans to lower capital requirements for banks and said the move could direct investment into energy-efficient areas. However, the idea is sensitive for regulators, which use bank capital requirements to ensure the safety of financial institutions. A past similar move earned a rebuke from the Basel Committee for violating international standards intended to prevent financial crisis. In the Paris agreement, almost 200 countries committed to hold the increase in the global average temperature to well below 2 Celsius above pre-industrial levels. A strong EU-wide conclusion regarding the plan cannot be reached at this stage. (FT)

Government, RBI unlikely to give nod to SEBI's 'loan default disclosure' proposal (Economic Times)

China regulator unveils draft rules on limiting bank exposure (Reuters)

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