CreditOutlook

Credit Implications of Current Events

26 MARCH 2018

NEWS & ANALYSIS

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US tobacco companies and settlement bonds face potentially credit-negative rules for menthol and flavored cigarettes

Last Tuesday, the US Food and Drug Administration (FDA) said it is seeking information on the role that flavors, including menthol, play in attracting and addicting young people to cigarettes and other tobacco products. The announcement does not immediately enact new regulation, but begins a lengthy rulemaking process that the FDA said could ultimately result in higher tobacco product standards and restrictions on the sale and distribution of flavored tobacco products.

Such rules, if enacted, would be credit negative for tobacco companies Altria Group Inc. (A3 stable), Vector Group Ltd. (B2 stable) and Reynolds American Inc. (Baa2 no outlook), which makes Newport, the top-selling menthol cigarette brand in the US. If enacted, the rules would accelerate the overall volume decline in cigarette sales that has been ongoing for years. Cigarette sales volume has fallen 3%-4% a year since 2004 because of increased awareness of smoking's health consequences, more prevention efforts and anti-smoking laws. On 15 March, the FDA said it officially began a lengthy, previously announced regulatory process to reduce nicotine in cigarettes to less- or non-addictive levels.

If any specific restrictions on menthol-flavored cigarettes are enacted, the effect also would be credit negative for the longer-dated tobacco settlement bonds backed by Master Settlement Agreement payments. Tobacco manufacturers make the payments to various states based on the volume of US combustible cigarette shipments. These shipments likely would decline if restrictions on menthol flavored cigarettes are enacted and would lead to a drop in the revenue available to the tobacco settlement bonds. The lower the cigarette shipment volume, the less cash is available for payments on the tobacco bonds.

In its announcement Tuesday, the FDA said that it will seek comments for the next 90 days, or through 19 June 2018, on how menthol and other flavorings make cigarettes, cigars and other tobacco products, including chewing tobacco and e-cigarettes, more addictive and dangerous, and, if so, what the FDA should do about it. FDA Commissioner Scott Gottlieb said that the agency's main goal is to prevent underage people from beginning to use tobacco products. He noted that e-cigarettes are the most commonly used tobacco product among middle- and high-school students, who consistently report product flavoring as a reason for using them. Therefore, the FDA believes restrictions on menthol or other flavored tobacco products would deter a portion of new smokers from becoming addicted to nicotine.

Mr. Gottlieb said that the FDA also will study how certain flavors may help currently addicted adult smokers switch to potentially less harmful forms of nicotine-containing tobacco products, including e-cigarettes. Therefore, we expect that the FDA's proposed rulemaking will accelerate a debate over e-cigarettes' health risks and potential benefits. According to Euromonitor, e-cigarettes and related products account for just about 4% of US tobacco-related revenue, but sales are likely to more than double by 2020.

The FDA said there is no timeline for implementing any flavor restrictions, which are likely years away. The agency in 2009 banned certain flavors from cigarettes, but excluded menthol, as well as other tobacco products, including e-cigarettes, from those rules.

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Wynn Resorts' sale of newly issued stock to Galaxy Entertainment Group is credit positive

On Friday, Wynn Resorts, Limited (Ba3 negative) announced that it had agreed to sell 5.3 million newly issued shares of common stock at $175 per share to Galaxy Entertainment Group for about $927.5 million, a credit positive. Galaxy Entertainment Group is one of the world's leading resorts, hospitality and gaming companies and primarily develops and operates a large portfolio of integrated resort, retail, dining, hotel and gaming facilities in Macau. Wynn intends to use proceeds from the share offering to repay up to $800 million borrowed under a 364-day term loan facility that it entered earlier this month.

With nearly $1 billion of cash, we expect that Wynn's net debt/EBITDA on a Moody's-adjusted basis will be about 5.5x in each of the next two years, higher than what is was in 2017, but still a half-turn below our quantitative downward rating guidance of 6.0x debt/EBITDA. Wynn's net debt/EBITDA for 2017 was about 4.6x.

Based on our current estimate of the cash inflows and outflows for Wynn in 2018 and 2019, including the proceeds from the stock sale to Galaxy and a $2.4 billion cash settlement that fully satisfies Wynn's promissory note obligation to Universal Entertainment Corp., we estimate that Wynn will need to fill a $2 billion funding gap. Based on this assumption and assuming the company decides to fund 100% of the $2 billion funding gap with debt, we estimate that Wynn's pro forma Moody's-adjusted net debt/EBITDA ratio would be 5.5x, which is within our expectation for its Ba3 rating.

In addition to the receipt of $927.5 million from the stock sale to Galaxy, and the payment of a $2.4 billion cash settlement to Universal, cash inflows and outflows that form the basis of our analysis include our estimate of Wynn's EBITDA, working capital, cash interest, cash dividends, scheduled debt maturities, maintenance and all development capital expenditures, and pre-opening expenses. Our negative outlook considers that although Mr. Wynn will no longer be part of Wynn Resorts, the reputation, financial performance, and licensing status of the company's casino assets, which bear Mr. Wynn's name, risk being harmed by perception alone. We could revise Wynn's rating outlook to stable from negative if we believe that the company's reputation and financial performance will not be impaired as a result of the allegations against Mr. Wynn, and that the company is able to maintain its Nevada, Macau and Massachusetts gaming licenses in good standing.

NEWS & ANALYSIS

Credit implications of current events

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Alpek's acquisition of a stake in chemical plant will bolster a rebound in earnings and leverage

Last Wednesday, Mexican chemical company Alpek S.A.B. de C.V. (Baa3 stable) said that it will spend $375 million as part of a $1.1 billion joint-venture agreement to buy a purified terephthalic acid (PTA) and polyethylene terephthalate (PET) chemical plant in Corpus Christi, Texas, plus various related assets, from Mossi & Ghisolfi USA (M&G). The deal is credit positive for Alpek, giving it access to one-third of the capacity of the plant, the world's largest PTA-PET production facility. Alpek, which generated about $5.2 billion in revenue and $384 million in EBITDA in 2017, will share the costs and ownership equally with its two partners, Thailand's Indorama Ventures Holdings LP and Taiwan's Far Eastern Investment.

Buying a stake in the M&G facility ensures more reliable earnings for Alpek now that M&G, a major Alpek customer, has entered bankruptcy protection. The additional production will account for 18%-19% of Alpek's total PTA and PET current installed capacity. PTA is the principal feedstock needed to produce PET, a key ingredient in plastic bottles.

The Corpus Christi project still requires an investment of $500 million over 2019-20 that the three joint-venture partners will finance equally. Once completed, the plant will be the world's largest vertically integrated PTA-PET production facility, adding 1.1 million tons of installed PET capacity and 1.3 million tons of PTA capacity. Alpek expects the deal to close in 2018.

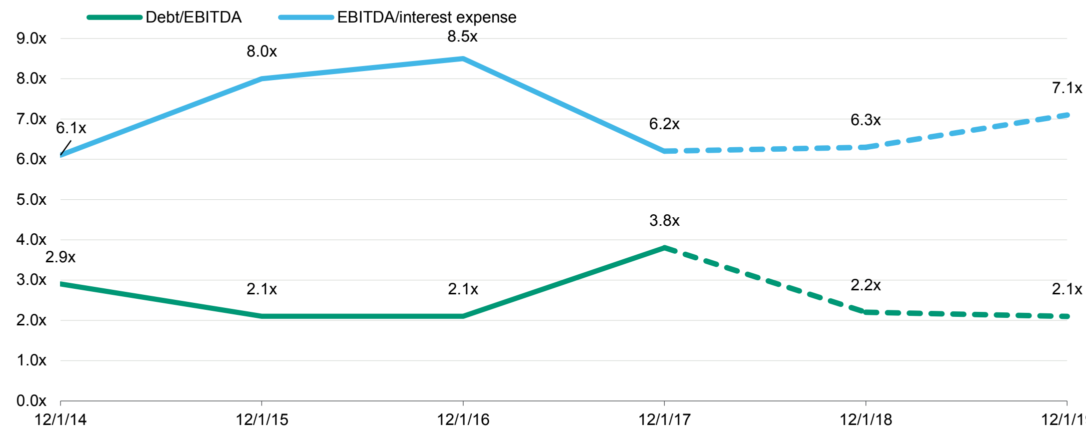
Alpek will finance its stake in the joint venture with a combination of cash and a portion of the $435 million in capital it has already invested in the project. The company has enough liquidity to finance its share of the transaction without raising any additional debt: the company had cash of MXN9.6 billion ($484 million) as of 31 December 2017, or 1.1x its short-term debt. Alpek still has 40% available among its $430 million in five domestic and foreign committed facilities, expiring in 2018-20, as well as about $430 million in revolving credit to cover seasonal cash requirements.

Along with the integrated PTA-PET plant, which is now under construction, Alpek is buying one-third of the rights to certain M&G intellectual property, and to a desalination/boiler plant that provides water and steam for the plant.

Alpek's exposure to financial difficulties at M&G, its largest customer accounting for 10%-11% of consolidated revenue, weakened its own operating and credit metrics in 2017. In September, M&G Mexico failed to pay Alpek for its supply of PTA, and in October M&G's US and Italian subsidiaries filed for bankruptcy protection owing to liquidity constraints. Since then, M&G Mexico shut down its PET production in Mexico after Alpek suspended its supply of PTA, forcing Alpek to record a $113 million provision for account receivables impairment that reduced its third-quarter 2017 EBITDA. As a result, Alpek's EBITDA margin, including our standard adjustments, declined to 10.3% in 2017 from 14.6% in 2016, while its adjusted debt/EBITDA ratio increased to 3.8x from 2.1x.

Buying a one-third stake in the new PTA-PET facility will not delay Alpek reducing leverage toward its historical level of an adjusted debt/EBITDA ratio of 2.1x by the end of 2018, or raising its adjusted EBITDA margin to around 12%, depending on the recovery in PET margins in North America (see exhibit). Stronger oil prices, higher polyester margins in Asia, and a recovery in paraxylene and monoethylene glycol prices also will benefit Alpek's polyester business, and therefore its margins and leverage, in 2018.

Alpek's credit metrics will improve in 2018



Sources: Moody's Financial Metrics and Moody's Investors Service forecasts

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Votorantim's cash windfall from Fibria-Suzano merger is credit positive

On 16 March, Brazilian mining conglomerate Votorantim S.A. (Ba2 negative) announced that it had agreed to sell its nearly 30% stake in Fibria Celulose S.A. (Ba1 negative) to Suzano Papel e Celulose S.A. (Ba1 negative) as Fibria and Suzano prepare to merge in a deal worth about BRL37 billion. Although domestic and foreign antitrust approval could take a year, the sale is credit positive for Votorantim, generating roughly BRL8.5 billion ($2.4 billion) that the company can at least partly use to retire debt.

Votorantim, which today owns 29.42% of Fibria's common stock, also will receive about BRL2.4 billion worth of common shares in Suzano when the merger closes for a 5.6% stake in the combined entity. Under the deal, Suzano will pay Fibria's shareholders about BRL29.0 billion in cash at the closing of its merger with Fibria, or about BRL52.50 per share, plus 0.4611 of a common share in Suzano for each common share of Fibria, worth another BRL8.0 billion at the price just before the announcement of the deal.

Although Votorantim has not disclosed how it will use its proceeds from the sale, the additional cash will significantly strengthen its balance sheet and give it considerable capacity to reduce debt. Votorantim generated about BRL27 billion in revenue during the 12 months through September 2017. We estimate that the company had around BRL10 billion of cash on its balance sheet at the end of 2017, an amount that would reflect recent asset divestments, debt amortizations, and an initial public offering of its Nexa Resources S.A. (Ba2 stable) subsidiary. Votorantim had about BRL24 billion of consolidated debt as of the same date.

The BRL8.5 billion cash injection within the next year can only help strengthen Votorantim's leverage ratio. Votorantim has a very comfortable debt maturity profile, but leverage has increased in recent years amid slowing demand for cement, one of the conglomerate's largest business segments. Debt/EBITDA was 5.3x as of September 2017, including our adjustments, up from 3.0x as of December 2014. We expect that Votorantim will be able to reduce leverage to about 4.0x in 2018 with further debt amortizations and improvements in cash generation – even without accounting for the sale of its Fibria stake.

Along with Votorantim, Fibria's other major shareholders include Banco Nacional de Desenvolvimento Economico e Social - BNDES (Ba3 stable/Ba2 negative, ba2[1]) and Suzano Holding S.A.

[1] The bank ratings shown in this report are BNDES' deposit rating, senior unsecured debt rating and Baseline Credit Assessment.

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Vivendi's sale of its stake in video gaming company Ubisoft is credit positive

On Tuesday, Vivendi SA (Baa2 stable) announced that it had entered agreements to sell its 27.27% interest in video gaming company Ubisoft at a price of €66 per share, yielding €2 billion of proceeds for Vivendi, which acquired its stake over several years for €794 million.

The sale of the Ubisoft shares is credit positive for Vivendi's because it will improve the company's liquidity and business profile.

The sale will provide Vivendi with an additional €2 billion of cash (€1.5 billion that Vivendi has already received and €500 million that it will receive in October) doubling the company's cash balance as of year-end 2017. Our central scenario for the use of the proceeds is that the €2 billion will not be used for extraordinary shareholder returns. In line with its stated intention to invest strategically across a number of content providers and media owners, we believe that Vivendi will choose to use the proceeds from the Ubisoft sale for future strategic investments or M&A.

Vivendi in the past has indicated that it would seek to increase its video gaming activities. However, its relationship with Ubisoft's top management and the company's founders was contentious for years. With Ubisoft's founders vocally opposed to Vivendi's involvement in Ubisoft, a takeover most likely would have been hostile, complex to implement and at a high multiple that would have weakened Vivendi's credit metrics.

The video game industry also is inherently more volatile than Vivendi's other businesses, in particular its subscription-backed music and pay-TV businesses, because its performance relies on the success of hit games. Therefore, we view the sale of Ubisoft as strengthening Vivendi's overall business profile.

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For Klépierre, buying Hammerson would improve business profile, but offer terms will be key to credit profile

On Monday, French real estate investment trust (REIT) Klépierre S.A. disclosed that it had made a proposal to acquire UK REIT Hammerson Plc (Baa1 stable) for £4.8 billion, excluding debt. The consideration equals 615 pence per ordinary share, a 35% premium to Hammerson's prevailing share price at the time that Klépierre made the proposal on 8 March, and would comprise 50% cash and 50% Klépierre shares, according to Hammerson. Although acquiring Hammerson would strengthen Klépierre's already-solid market position in Europe and the UK, an acquisition that includes debt risks deteriorating Klépierre's key debt metrics.

At the 615-pence-per-share offer price and if Klépierre were to fund the offer's 50% cash component with debt, we estimate that its pro forma ratio of debt to assets would increase to around 46% from 38.4% as of year-end 2017, putting it above the 40%-45% quantitative range that we currently expect for an A3 rating. Additionally, its fixed charges coverage ratio would deteriorate to around 4.0x from 5.9x at the end of 2017. Klépierre's current financial policy targets a loan-to-value ratio of 35%-40% on a reported basis.

An acquisition of Hammerson, whose board of directors rejected Klépierre's bid on the basis that it significantly undervalues the target, would support Klépierre's position as the second-largest property company in Europe and the third-largest globally with around €1.5 billion of net rental income. Hammerson is the leading shopping center landlord in the UK, and owns 10 of the top 50 shopping centers there and a portfolio mostly composed of grade-A properties, according to Green Street Advisers. Although retailers face challenges because of growing e-commerce penetration and redesigns of their retail channels, we believe that prime shopping centers such as those owned by both Hammerson and Klépierre will continue to attract demand from international tenants.

On a pro forma basis, Klépierre's total assets would increase to around €37 billion from €25 billion as of year-end 2017, and its geographic diversification would further improve mostly through the addition of Hammerson's shopping centers in the UK. Klépierre's exposure to France would fall to a pro forma 30% of gross asset value (GAV) as of year-end 2017 from an actual 37%, while its exposure to Italy would drop to 11% from 17%, and the UK would constitute around 16% and become its second-largest market. Through Hammerson, Klépierre also would acquire exposure to premium outlets, a rapidly growing and attractive asset class that would contribute approximately 7% of the combined GAV.

Based on the high level terms of Klépierre's potential offer, Hammerson's bondholders could benefit from becoming lenders to a larger and more diversified group. Its leverage (as measured by debt to assets) would be at around 46%, above Hammerson's ratio of 41% pro forma for a potential merger with Intu, a UK property company whose portfolio as of June 2017 had a value of £9.7 billion. We also note that Hammerson's offer to acquire Intu included planned disposals of at least £2 billion to reduce leverage, and that Hammerson has a good track record of completing disposals. Our estimate of Hammerson's debt-to-asset ratio is based on the proportional consolidation of its joint ventures and on the equity consolidation (net asset values) of its 40% interest in Value Retail and its 47% stake in Via Outlets, the company's two luxury outlet destinations.

Hammerson's bonds have change-of-control clauses applicable only if we downgrade the company to sub-investment grade or withdraw the rating. According to UK takeover rules, Klépierre must announce by 16 April whether it intends to make a firm offer or not.

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Naspers reduces its stake in Tencent, a credit positive

On Friday, Naspers Limited (Baa3 stable) announced that it had reduced its stake in Tencent Holdings Limited (A1 stable) to 31.2% from 33.2% for proceeds of $9.8 billion through an accelerated offering to investors. The disposal is credit positive for Naspers because it strengthens the company's balance sheet to fund a scaling of its core e-commerce operations and pursue new acquisitions without incurring additional debt.

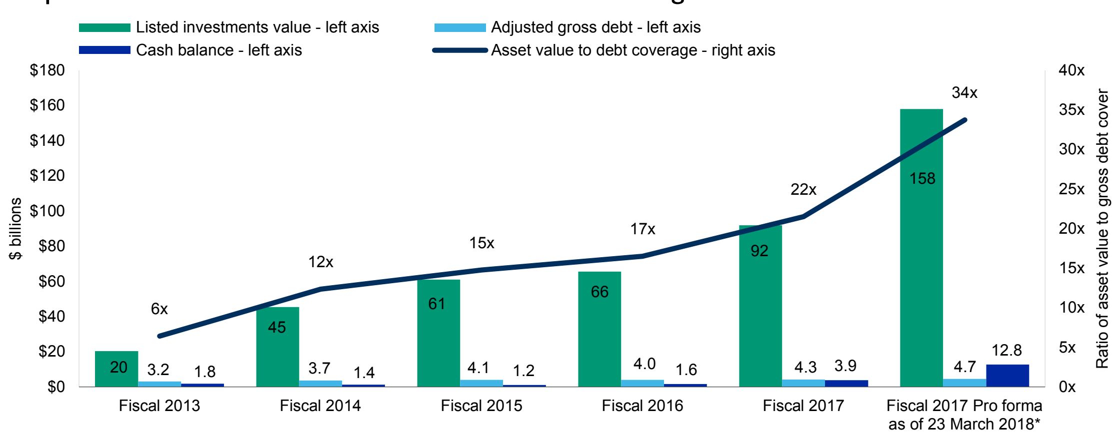
The proceeds increase Naspers' cash balances to around $12.8 billion from $3.0 billion as of 30 September 2017, and puts the company back into a net cash position of around $8.1 billion after deducting $4.7 billion of adjusted gross debt (including transponder leases). The company expects the capital gains tax liability on the $9.8 billion of proceeds to be minimal and would be applicable to the extent that South African investors participated in the Tencent share sale.

We do not expect Naspers to use the proceeds to reduce debt given its long-dated debt maturity profile at competitive funding rates, with the next bond of $1 billion and its $2.5 billion undrawn revolving credit facility maturing in 2020. Instead, we expect Naspers to redeploy the capital into new growth opportunities. Although the timing and magnitude of future acquisitions or investment demands from its existing operations remain unclear, based on historical capital demands, we expect that the sizable cash balance and undrawn $2.5 billion revolving credit facility will alleviate the need to raise additional debt for some time.

The disposal shows Naspers' preference and willingness to monetise valuable investments instead of increasing debt. It is consistent with our expectation that Naspers will maintain a prudent financial policy against a growth strategy that requires a high initial capital investment to broaden its reach and entrench its market-leading positions in its core e-commerce businesses including classifieds, food delivery and financial technology.

The cash proceeds will strengthen the company's Moody's-adjusted market value leverage ratio (measured as market value/net debt) to negative 4.7x from positive 0.9x owing to Naspers' net cash position. The remaining 31.2% stake in Tencent still has significant value of $155 billion at current market prices, and when combined with Naspers' other listed investments in Mail.ru Group Limited ($2.2 billion), Delivery Hero AG ($2.0 billion) and MakeMyTrip Limited ($1.1 billion) would cover Naspers' reported debt obligations by more than 46x, or by 34x using Moody's-adjusted gross debt (see exhibit).

Naspers' total listed investments' values continue to exceed gross debt balances



Fiscal years end 31 March.
* Cash and debt are as of 30 September 2017, and listed investments values are as of 23 March 2018, after the sale of the Tencent stake.
Sources: Naspers financial statements, Bloomberg and Moody's Investor Service

We estimate that there will be a negligible effect on Naspers from the reduced dividend inflow from Tencent as a result of the smaller stake. Our holding company cash interest coverage ratio, as measured by dividends received less head-office cost/net interest expense, was around 2.9x as of 30 September 2017 and would fall to around 2.8x. This excludes any anticipated growth in future dividends from Tencent; Naspers' share of Tencent dividends was $247 million in 2018 versus $100 million in 2015.

Infrastructure

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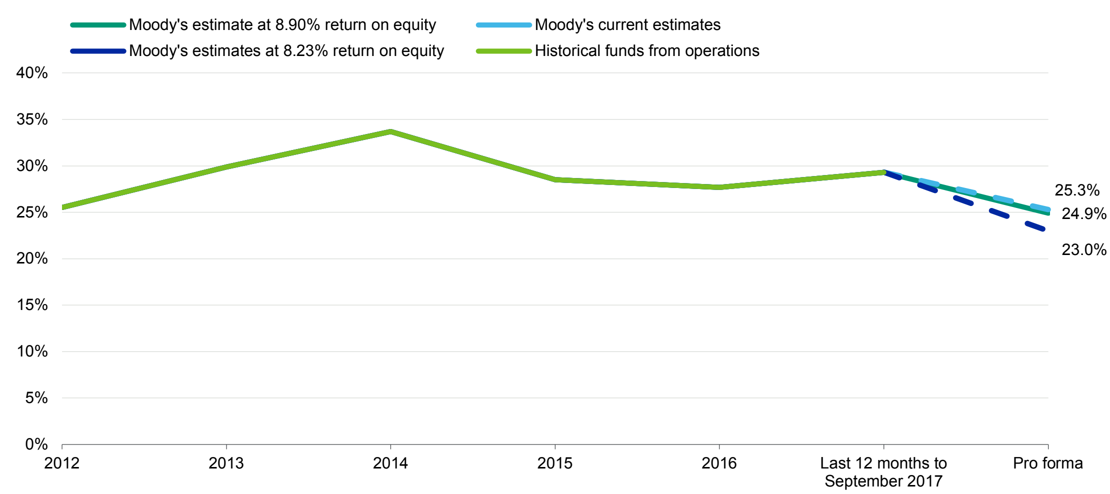
California regulator's approved cost of capital decision is credit positive for Golden State Water

Last Thursday, the California Public Utilities Commission (CPUC) unanimously approved an administrative law judge's proposed decision in the cost of capital proceeding for four investor-owned regulated water utilities. The revised decision includes a return on equity (ROE) of 8.90%-9.22% and revised capital structures. The approval is credit positive for Golden State Water Company (A2 positive), a subsidiary of American States Water Company, because it will help Golden State maintain a ratio of funds from operations (FFO) to debt of around 25% (including the effect of tax reform), versus the CPUC staff and original administration law judge's recommendation that reduced the ratio to about 23%.

Additionally, the CPUC decision is credit positive for Golden State and other California water utilities including California Water Service Company, American Water Works Company, Inc. (A3 negative) subsidiary California American Water Company, and San Jose Water Company because it shows the CPUC's continued support for their financial metrics. It also eliminates regulatory uncertainty related to a possible negative outcome of the cost of capital proceeding without significantly hurting the companies' future cash flows and financial metrics.

The approved cost of capital proceeding increases Golden State's equity layer to 57% from the 55% resulting from a 2012 settlement, which mostly offsets the ROE reduction to 8.90% from 9.43% currently. Although lower than the current ROE, 8.90% is significantly higher than the CPUC's Office of Ratepayer Advocates (ORA) and original administrative law judge's proposed decision, which included an ROE of 8.23% and a lower equity layer for Golden State. Under Wednesday's CPUC-approved decision, we expect Golden State's FFO to decrease by less than $2 million, or about 1.5%, and its FFO-to-debt ratio to shrink by around 40 basis points and remain in the mid-20% range. In contrast, we estimate that the initial ORA and administrative law judge proposal would have cut Golden State's FFO by $8 million, or about 10%, and would have reduced the FFO-to-debt ratio by around 230 basis points to the low-20% range (see exhibit).

Golden State Water's FFO-to-debt ratio, historical and Moody's estimates with revised and original ROE allowance



Source: Moody's Investors Service

The CPUC's continued support for water utilities' credit is important because it sets the foundation of rates going forward, which ultimately will be determined in December 2018. California's regulatory environment historically has been supportive and highly predictable, which has been the key credit driver for California's water utilities

The approval of the administrative law judge's revised proposed decision was mainly underpinned by the CPUC's view that these utilities are not nearly as risk-free as originally stated by the judge, and that big utilities acquiring smaller utilities is positive for the sector's efficiency and reliability, but carries additional risks.

Banks

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Deutsche Bank passes a credit-positive milestone with IPO of DWS Asset Management

On Friday, Deutsche Bank AG (A3 stable/Baa2 negative, ba1[2]) executed a partial initial public offering (IPO) of 22.25% of its asset management operation, DWS Group GmbH & Co. KGaA, now rebranded as DWS. This is an important milestone in Deutsche Bank's reengineering and also will generate a modest Common Equity Tier 1 (CET1) capital benefit. The 22.25% flotation of DWS is credit positive because it enhances Deutsche Bank's ability to grow its asset management business. Strengthening the profitability and increasing the growth of this capital-light business is vital to management's strategic objective to rebalance the bank's risk profile and earnings mix.

With a public float, DWS can offer employees equity-based compensation linked purely to DWS results. This should help DWS recruit and retain intellectual capital, which is important to driving the superior investment performance that attracts new asset flows into high-margin asset classes. DWS shares can be used in future acquisitions within the asset management business, which we expect to consolidate given rising technological and regulatory demands. The flotation also bolsters Deutsche Bank's CET1 ratio, which management intends to maintain comfortably above 13%, and as of 1 January 2018 was 13.8%. These benefits more than offset the dilution to Deutsche Bank bondholders from sharing 22.25% of DWS' earnings stream with minority investors.

Exhibit 1 shows key performance indicators for DWS. Assets under management (AUM) and revenue both recovered in 2017 after declining in 2016 as a result of difficult market conditions and specific challenges related to Deutsche Bank that year, including negative market perceptions about the company.

EXHIBIT 1
Evolution of DWS' key performance indicators

	2015	2016	2017
Revenue, € billions	€2,618	€2,357	€2,456
Pre-tax income, € billions	€731	€709	€747
Assets under management, € billions	€714	€689	€700
Pre-tax margin, %	28%	30%	30%
Pre-tax income/assets under management, basis points	10	10	11
Management fee margin, basis points	31.5	30.9	31.5

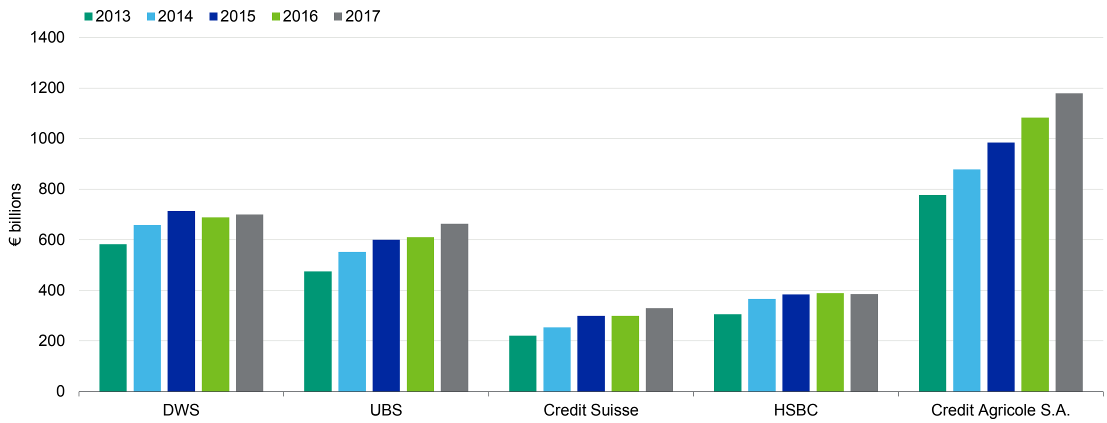
DWS adjusted data
Source: The company

Deutsche Bank contemplated exiting the asset management business in 2012, but after management decided to keep it, began reengineering it and the rest of the bank in earnest. Today, DWS has substantial scale and balance by geography, investor type and investment style. As of 31 December, Germany accounted for 42% of DWS' AUM, the rest of Europe, Middle East and Africa contributed 25%, the Americas 28% and Asia-Pacific 5%. By investor type, AUM is split 54% institutional and 46% retail; 74% is actively managed, 16% is passive and 10% is alternative.

[2] The bank ratings shown in this report are Deutsche Bank's deposit rating, senior unsecured debt rating and Baseline Credit Assessment. The negative outlook on senior debt also applies to all German banks relating to changes to the European Union's Bank Recovery and Resolution Directive, which may reduce the likelihood of German government support for senior bank debt.

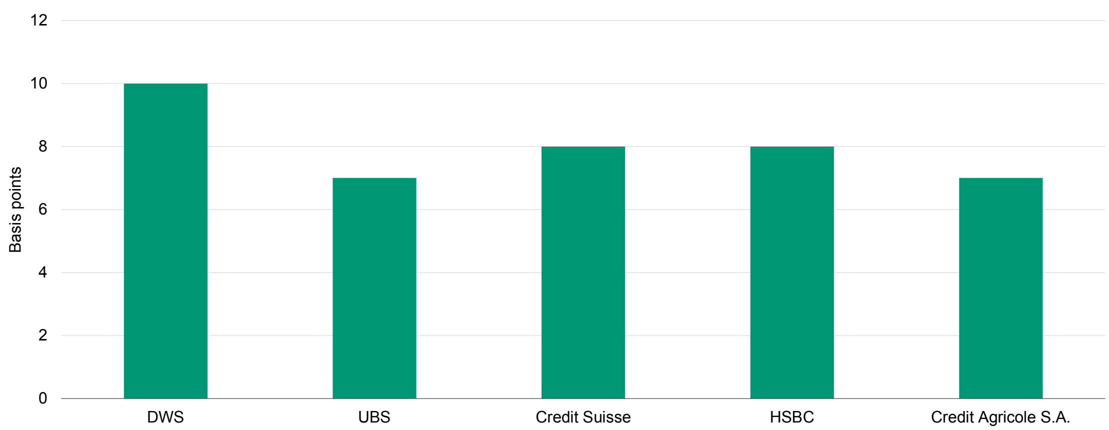
Exhibits 2 and 3 compare DWS' scale and profitability with the asset management franchises of certain European competitors, and show that DWS compares favorably with most peers based on these metrics. DWS' scale, profitability and diversification will be important competitive strengths in an overcrowded global asset management industry facing fee pressures and evolving client demands.

EXHIBIT 2
Large European banks' assets under management



Credit Agricole S.A.'s assets under management are adjusted for the acquisition of Pioneer Investments in 2017.
Sources: Company reports

EXHIBIT 3
Large European banks' ratio of asset management pre-tax income to assets under management as of the end of 2017



We use DWS' reported data for DB Asset Management for comparison purposes
Sources: Company reports

Management intends to maintain a management fee margin (recurring revenue over AUM) of at least 30 basis points, with the goal of growing selected higher margin asset classes such as alternatives more quickly. Maintaining a 30-basis-point management fee margin is important to the goal of achieving a 65% of cost-to-income ratio for DWS, but this may be challenging. Fee pressure is pervasive across investment styles and greater transparency in fees and charges induced by the revamped Markets in Financial Instruments Directive (MIFID II) will push investors toward low-cost funds such as exchange-traded funds and other passive alternatives. Nonetheless, although challenges remain, floating a portion of DWS enhances Deutsche Bank's strategic flexibility to grow its asset management franchise.

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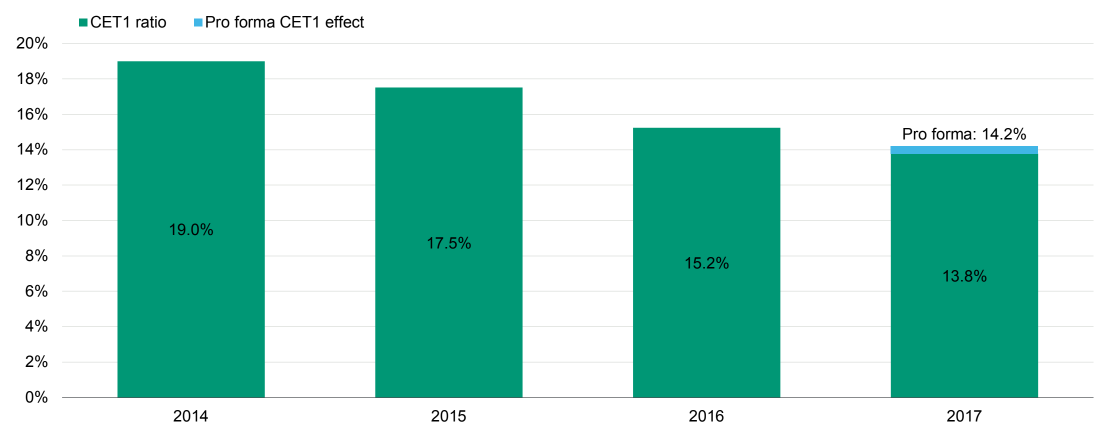
Virgin Money establishes new credit-positive joint venture with Aberdeen Standard Investments

Last Tuesday, Virgin Money Holdings (UK) plc (VMH, Baa3 stable) and Aberdeen Standard Investments (ASI), a subsidiary of Standard Life Aberdeen plc (A3 stable [multiple]), announced a joint venture for the provision of asset management services. Under the expected terms of the agreement, ASI will acquire 50% of Virgin Money Unit Trust Managers Limited (VMUTM) for an upfront cash payment in excess of £40 million. The joint venture is credit positive for VMH because it will increase its capitalisation and expand its retail investments offering, potentially increasing its income diversification.

We calculate that VMH's Common Equity Tier 1 (CET1) ratio will increase to 14.2% from 13.8% at the end of December 2017 (see exhibit) based on its capitalisation, mitigating a 1.4-percentage-point CET1 ratio decline that VMH reported in 2017. We expect that VMH will use the proceeds to continue supporting lending growth in its main operating entity, Virgin Money plc (VM, Baa2 positive, baa2[3]). VM's strong mortgage and credit card loan growth in recent years have been the main source of a material increase in VMH's risk-weighted assets (RWAs), with a compound annual growth rate (CAGR) of 21.2% for RWAs between 2014 and 2017. The RWA growth has outpaced CET1 capital growth, which had a CAGR of 8.8% during the same period.

Virgin Money Holding's joint venture with ASI partially mitigates its declining CET1 ratio



Sources: Company reports and Moody's Investors Service

Although the partnership allows VMH growth in a capital-light business line, we expect VMH's CET1 ratio to continue declining this year, driven by lending growth, although at a slower pace compared with the past three years.

The partnership with ASI increases the likelihood that VMUTM, which had £3.7 billion of assets under management (AUM) at the end of 2017, will increase its cross-selling penetration among VMH's 3.3 million customers and thereby increase non-interest income. ASI, which had €638 billion (around £560 billion) of AUM at 30 September 2017, will contribute with its expertise and broader product offering.

[3] The ratings shown in this report are Virgin Money plc's deposit rating and Baseline Credit Assessment.

Over time, the joint venture will improve VMH's income diversification, which has increasingly been concentrated around interest income from retail mortgages and credit cards. The overall income contribution of the Financial Services business line, of which VMUTM is a part, declined to 5.6% of total income in 2017 from 7.5% in 2014. Since 50% of VMUTM's income will be attributable to ASI, we expect that the transaction will negatively affect profit in the early stages of the partnership. If we assume that VMUTM's profit remains about the same as in 2017, VMH's overall profits in 2019 will drop by around 3% from our previous expectation. Because the transaction is subject to regulatory approval and is unlikely to close until the end of the year, we expect no material effect on profit in 2018.

NEWS & ANALYSIS

Credit implications of current events

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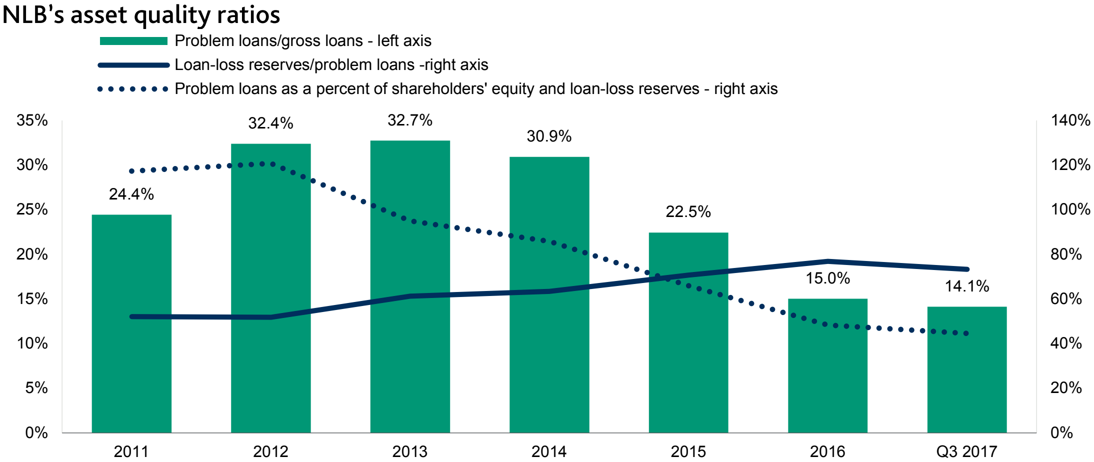
NLB's plan to sell problem loans improves its financial strength

On 16 March, Nova Ljubljanska banka d.d. (NLB, Ba1 positive, b1[4]), Slovenia's largest bank, announced that it plans to sell a €115 million portfolio of nonperforming assets in its Serbian operation. The planned sale of nonperforming loans will benefit NLB's asset quality and overall solvency. NLB's high nonperforming loan ratio of 14.1% in September 2017 (see exhibit) is a key impediment in the recovery of its credit strength.

NLB's asset quality ratios



Sources: NLB and Moody's Investors Service

NLB is a financial group with a strategic focus on select markets in Southeastern Europe. NLB had a 23.1% market share of total banking assets in Slovenia in September 2017, and it has subsidiaries in Macedonia, Bosnia and Herzegovina, Kosovo, Serbia and Montenegro. The nonperforming assets earmarked for sale account for 30% of the Serbian subsidiary's total assets as of September 2017.

However, most of NLB's nonperforming loans derive from its core Slovenian business. Exposure to Slovenia's highly leveraged corporate sector has been a main driver of weak asset quality at NLB and other large Slovenian banks. These big banks were rescued by the government in 2013-14 through large-scale capital injections, resulting in their nationalisation and the transfer of some of the problem loans to state-owned bad bank, Bank Asset Management Company.

The Slovenian government has committed to the European Commission to reduce its stake in NLB to 25% plus one share to compensate for state aid provided during the bank's bailout. Slovenia planned to privatise at least 50% of NLB in 2017, however the plan was cancelled because the government did not agree with the price for the bank. In addition, the privatisation is hindered by lawsuits against NLB stemming from Yugoslav-era savings deposits that were held at Ljubljanska banka in Zagreb, Croatia. In order to protect NLB, the Slovenian parliament is considering legislative changes that would ban NLB from making payments based on the lawsuits. We expect that this legacy problem will be resolved without any material negative effect on NLB. Additionally, the continued improvements in the bank's asset quality will increase NLB's attractiveness to investors and underpin its privatisation efforts.

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4 The bank ratings shown in this report are the bank's domestic deposit rating and Baseline Credit Assessment.

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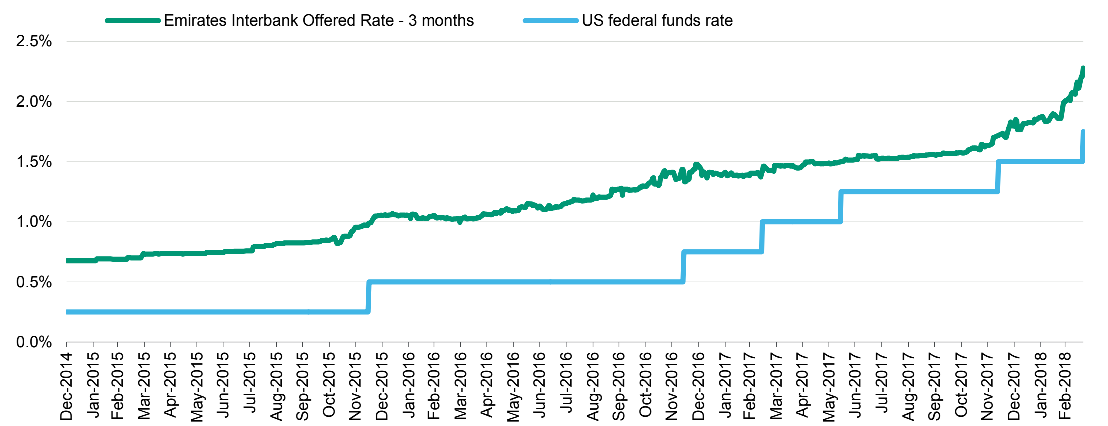
United Arab Emirates' banks will benefit from rising interest rates

Last Thursday, the Central Bank of the United Arab Emirates (CBUAE) raised interest rates on its certificates of deposit following the US Federal Reserve's 25-basis-point increase to the federal funds rate. The CBUAE also announced that it had increased its repo rate by 25 basis points to 2%. The rate hike is credit positive for United Arab Emirates (UAE) banks because it will support their profitability by increasing net interest income, which accounted for around 69% of rated UAE banks' total net revenue of around $19 billion during 2017 and is a key profitability driver.

Certificates of deposit, which the CBUAE issues to banks operating in the UAE, are the monetary policy instrument through which changes in interest rates are transmitted to the banking system. Given the currency peg of the UAE's local currency, the dirham, to the US dollar, rising US interest rates have historically translated into higher local currency rates in the UAE (see Exhibit 1).

EXHIBIT 1
UAE rates move in tandem with US rates given the currency peg



Source: Bloomberg

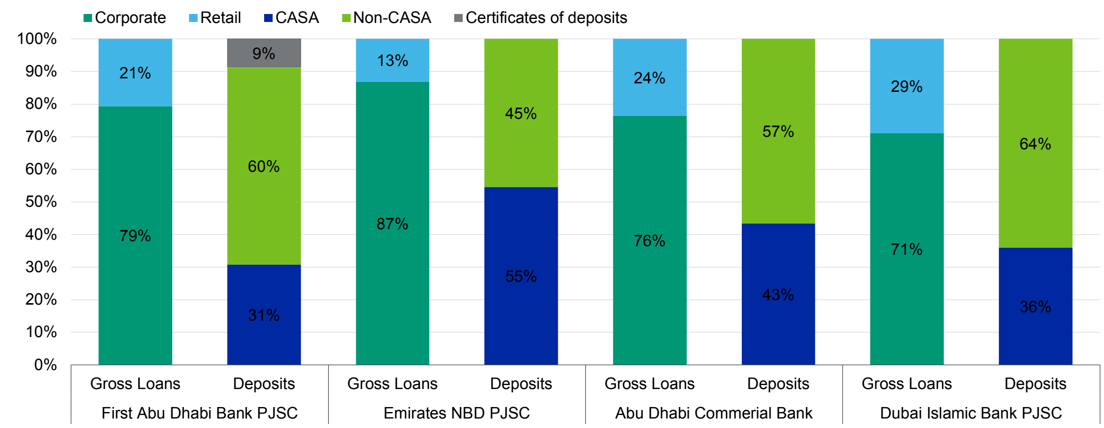
Funding costs for UAE banks have increased in recent years owing to a combination of lower oil prices and higher US rates. Oil price weakness during 2015-17 reduced the revenue of large bank depositors, including government-related issuers and large corporates, thereby increasing the cost of wholesale deposits from such large depositors. UAE banks' funding cost increased to 1.3% during the first half of 2017 from 1.2% in 2016 and 0.9% in 2014-15. Firmer oil prices and international bond issuance over recent quarters have since helped stabilise funding conditions in the country.

Such higher funding costs have challenged banks' net interest margins somewhat. This reflects the competitive nature of the local market (amid limited credit growth), combined with the focus of lenders on high-quality large corporations and government-related issuers (amid elevated delinquencies in the mid corporate and retail segments), which so far have constrained the pricing increase. UAE banks' net interest margin declined to 2.4% system-wide during the first half of 2017, from 2.5% in 2016 and 2.7% in 2015.

We expect that rising interest rates will support UAE banks' interest margins through higher gross yields, as banks gradually reprice their loan books while wholesale funding costs stabilise amid firmer oil prices. According to central bank data in January 2018, around 74% of UAE banks' loan books were predominantly composed of loans to the corporate and government sectors as of December 2017, and those loans typically carry floating rates that are gradually reset at pre-determined intervals.

We expect that the improvement in net interest income will vary by bank, with banks that have the highest proportion of corporate loans and the highest proportion of CASA deposits benefiting the most (see Exhibit 2). This is because corporate loans tend to be easier to reprice owing to their floating rates, while CASA deposits tend to be less price sensitive because of their transactional and operational nature.

EXHIBIT 2
Moody's-rated large UAE banks' loans and deposits composition



Corporate loans include loans to the government sector. CASA deposits include current, call, demand, short notice, margin and savings deposits.
Sources: Banks' financial statements

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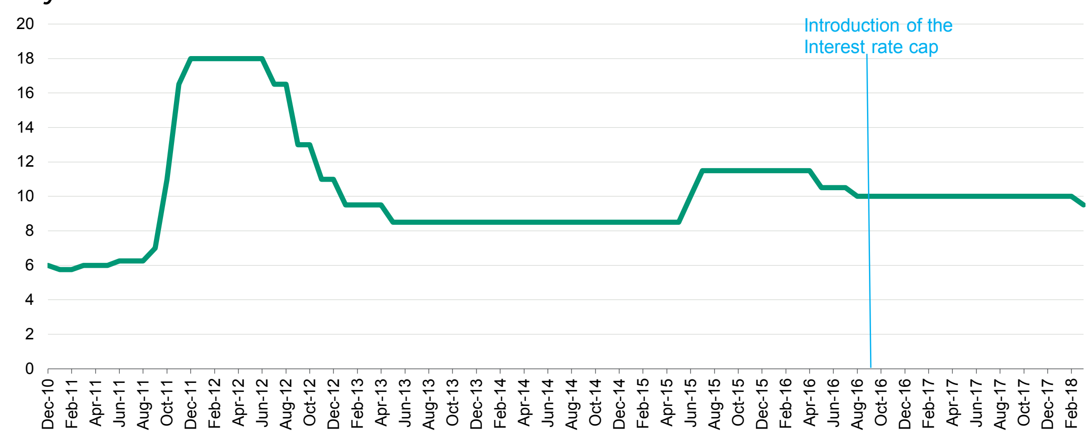
Kenyan banks' margins and profitability will decline because of central bank's rate cuts

On Monday, the Central Bank of Kenya (CBK) cut its key policy rate, the central bank rate (CBR), to 9.5% from 10%. The CBR reduction will lead to a 13.5% system-wide lending rate cap, down from 14%, a credit negative for banks because it will compress margins and constrain profitability. Although larger banks likely will experience greater margin compression, their stronger profitability will allow them to more easily absorb the hit than smaller banks.

The 9.5% CBR is the lowest rate in three years (see Exhibit 1) and is part of the CBK's effort to ease monetary policy and boost economic growth following a decline in economic growth to 5.3% in 2017 from 5.8% in 2016. Additionally, inflation of 4.5% in February 2018 is at the lower end of the CBK's 2.5%-7.5% target range, and down from 6.4% a year ago. Since September 2016, banks have been required to hold their lending rates at a maximum of 400 basis points above the CBR (13.5%), and their deposit rates on applicable deposits at a minimum of 70% of the CBR, or 6.65%.

EXHIBIT 1
Kenya's central bank rate



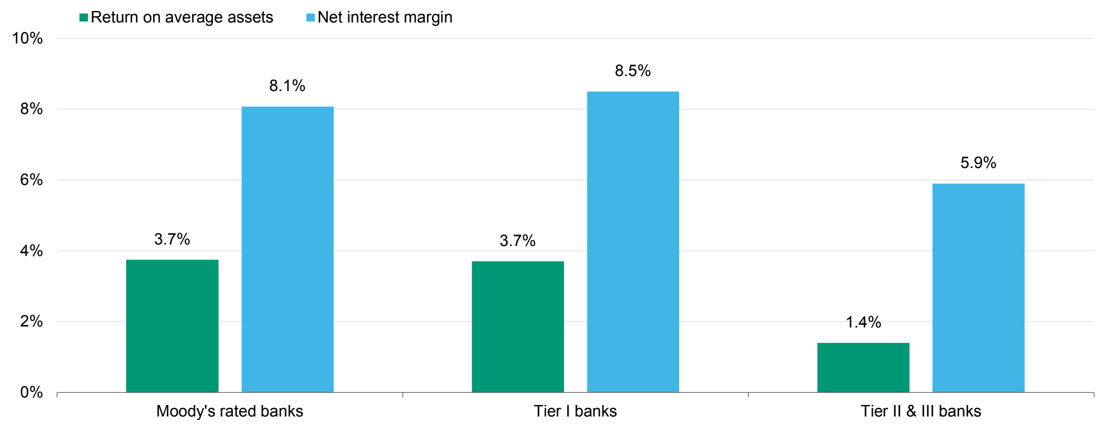
Source: Central Bank of Kenya

A lower lending rate cap will compress lending margins and weaken banks' profitability. Since the cap's introduction in September 2016, interest rate margins for rated banks have dropped by around 200 basis points to 8.1% as of September 2017. Although lower rates on applicable deposits will benefit banks in terms of lower funding costs, the effect will be limited given that more than half of the system's deposits as of 30 June 2017 were not constrained by the deposit rate floor.

We expect the largest banks in Kenya, including KCB Bank Kenya Limited (B2 stable, b2[5]), Equity Bank Kenya Limited (B2 stable, b2) and Co-operative Bank of Kenya Limited (B2 stable, b2), to experience larger drops in margins because the decline in lending rates will not be countered by a corresponding reduction in banks' cost of funds. These banks' funding costs are already low because 70% of their total deposits are outside the scope of the regulation. For smaller banks, the margin compression will be partly offset by a reduction in their funding costs because of their higher reliance on term and savings deposits. Nonetheless, large banks can still easily absorb the effect on margins because their profitability remains materially stronger than smaller banks (see Exhibit 2).

[5] The bank ratings shown in this report are the bank's domestic deposit rating and Baseline Credit Assessment.

Kenyan banks' profitability



Rated banks include KCB Bank Kenya Limited, Equity Bank of Kenya Limited and Co-operative Bank of Kenya Limited. Kenya's seven largest banks comprise Tier I banks, while a sample of 14 smaller banks comprise Tier II and III banks.

Source: Banks' financial reports, Moody's Investors Service and SNL Financial data

Given the current lending rate cap and banks' nonperforming loans at a high 11.4% of loans as of February 2018, the CBR rate cut likely will have a limited effect on economic and credit growth. CBK Governor Patrick Njoroge acknowledged as much, and stressed that the CBK is ready to take action to counter this. Based on his comments and those of other government officials, we believe changes to the current lending rate cap will be proposed by June 2018. A revision of the interest rate cap in a way that no longer constrains private-sector credit would support the CBK's effort to boost economic growth and increase credit growth.

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Bank of Ghana places Unibank under administration, signalling stricter regulatory stance, a credit positive

Last Tuesday, Bank of Ghana (BoG), the central bank, announced that it had placed Unibank Ghana Limited, Ghana's third-largest bank by assets, under administration because of its negative capital and persistent liquidity challenges. The BoG's action is credit positive for Ghanaian banks because it will enhance their long-term financial stability by removing weaker banks from the system and underscores the central bank's stricter enforcement of prudential guidelines. A stricter regulatory stance will lead to more reliable reporting and greater visibility on banks' true economic positions.

Unibank is the first large bank that BoG has placed under administration following its system-wide asset quality review in 2016. Unibank will remain open under an appointed administrator who assumes responsibility for the bank's affairs for six months, preparing it for rehabilitation and private ownership.

BoG's intervention follows Unibank's failure to restore its capital adequacy ratio to the required 10% and its strained liquidity among several other regulatory breaches. According to BoG, Unibank's capital adequacy ratio had deteriorated to negative 24.0% as of December 2017, from 4.8% in 2016 (see exhibit) because of high nonperforming loans and high asset growth. The bank's capital shortfall was GHS1.18 billion as of year-end 2017.

Unibank's capital adequacy ratio, 2016-17

Source: Bank of Ghana

Unibank's reserve ratio, a liquidity measure, was below 1% as of year-end 2017, which was substantially lower than the minimum regulatory requirement of 10%. Since 2015, Unibank has relied on BoG's Emergency Liquidity Assistance (ELA), and has needed GHS2.2 billion of liquidity support from the central bank over the past two years. Additionally, Unibank increasingly relied on interbank market funding as deposit growth stalled and contracted 4% in 2016 versus 2015. Interbank borrowings, which attracted an average interest rate of 25% in 2016, contributed 40% of Unibank's total funding liabilities, impairing its interest margin and profitability, and harming its ability to rebuild capital buffers via earnings retention.

The placement of Unibank under administration and the cancellation of licences for smaller banks UT Bank Limited and Capital Bank Limited in 2017 reflect BoG's tightened regulatory stance, which will limit banks' ability to game nonperforming loan classification and capital allocation. BoG's asset quality review in 2016 identified misclassification of nonperforming loans, under-provisioning and understating required capital. For example, Unibank's reported capital adequacy ratio was 12.6% at year-end 2016, but fell to 4.8% after BoG's review; the bank's reported nonperforming loans ratio was 5.3%, compared with a ratio of individually impaired loans to gross loans of 11.0%. Subsequently, BoG issued a guide on the loan review process and provisioning and increased the minimum capital requirement for banks to GHS400 million from GHS120 million. We expect these actions to lead to consolidation and result in fewer but larger banks, which likely will improve bank surveillance. BoG's action is also likely to induce other banks to mitigate excessive risk-taking, reduce unsustainable asset growth or increase capital buffers, making the system more resilient.

Although BoG indicated that no Unibank depositor will lose money, and that the bank will remain open, we expect depositor confidence, particularly for smaller banks and other weaker franchises, to be negatively affected over the next quarter. Because Ghana does not have an operational deposit insurance scheme, we expect a generalized withdrawal of deposits to large and stronger franchises, which will benefit banks such as GCB Bank Limited (B3 stable, b3[6]).

6 The bank ratings shown in this report are GCB Bank's deposit rating and Baseline Credit Assessment.

Insurers

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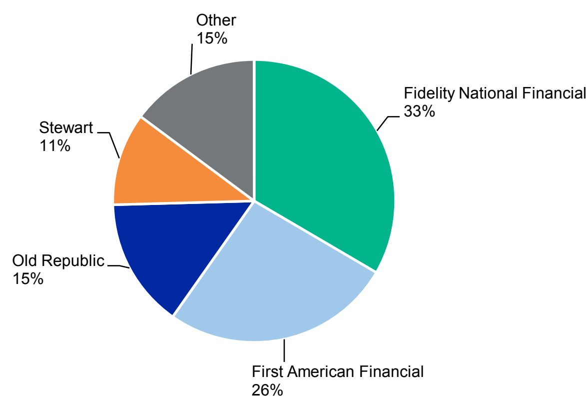
Fidelity National Financial's purchase of Stewart Information Services is credit positive

On Monday, Fidelity National Financial, Inc. (FNF, Baa3 positive) announced plans to acquire Stewart Information Services (STC) for $1.2 billion in cash and stock ($50 per STC share, a 5% premium to its closing price on 16 March). The proposed transaction is credit positive for FNF because it will increase the company's industry-leading market share in title insurance, and boost earnings through meaningful cost savings. The parties expect to complete the transaction in the first or second quarter of 2019, pending approvals by STC shareholders, various national and state regulators and other closing conditions.

Following the announcement, we affirmed FNF's ratings and the financial strength ratings of its US title insurance subsidiaries, Fidelity National Title Insurance Company, Chicago Title Insurance Company and Alamo Title Insurance Company (all A3 positive).

As Exhibit 1 shows, FNF is the largest US title insurer, with a 33% market share, and has a history of making acquisitions in the title space, as well as in other housing-related service areas. However, last year it spun off all non-title businesses. STC is the fourth-largest title insurer, with an 11% market share. The two companies are diversified geographically and operate in both the direct channel, owning their own individual title offices, and in the agent channel, using independent title agents.

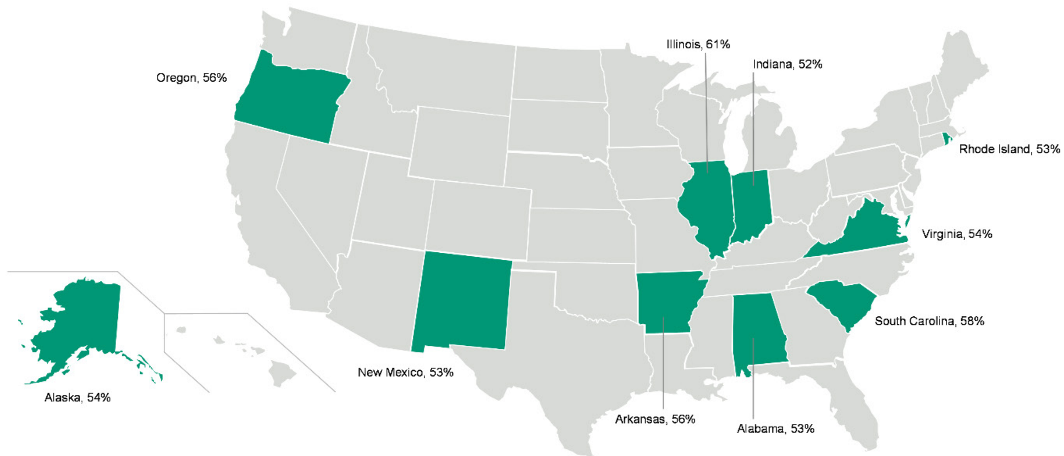
EXHIBIT 1
US title insurance market share for the first nine months of 2017



Sources: American Land Title Association and Moody's Investors Service

FNF has structured the transaction to issue a maximum amount of 5% of outstanding shares to STC shareholders. The sales price can be adjusted downward depending on whether FNF is required to relinquish STC businesses in various regulatory jurisdictions with high overlap. For illustrative purposes, Exhibit 2 highlights states where the combined company will have more than a 50% pro forma market share. Regulators generally review market share data by county, and in the areas where there are fewer than three competitors, FNF may be required to sell businesses.

EXHIBIT 2
States where FNF and STC combined will have a more than 50% pro forma market share



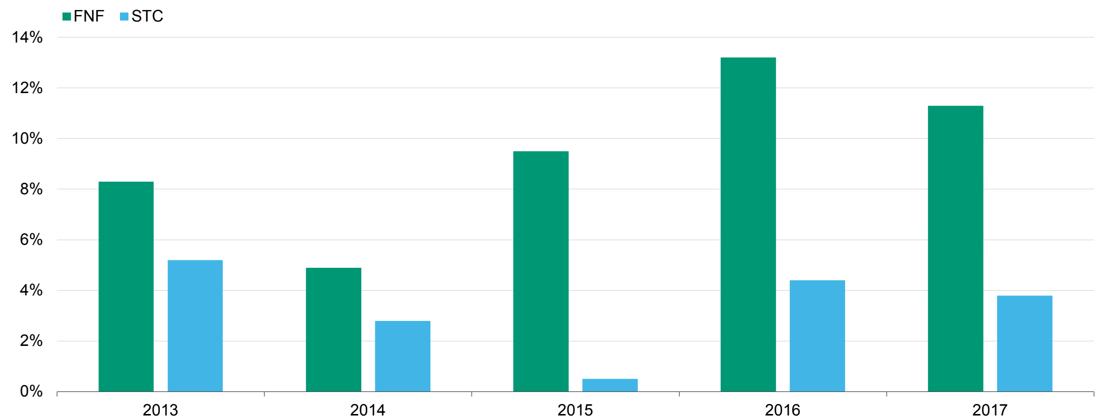
Sources: American Land Title Association and Moody's Investors Service

The decline in the purchase price consideration depends on the amount of revenue FNF must shed, and ranges from $75 million to $225 million. There also is a $50 million reverse breakup fee that FNF can pay to walk away from the transaction. We expect FNF's leverage to rise to around 20% from 13.6% as of 2017, even with the assumption of STC's $109 million in debt.

The pending acquisition is manageable for FNF, constituting about 11% of its market capitalization and 38% of its earned premiums. FNF's direct premiums were about $4.9 billion for 2017, while STC's were $1.9 billion. However, despite FNF's experience as an acquirer and the transaction's structure, the deal carries execution risk for FNF given that the gain in total market share above 40% in certain states could raise regulatory challenges. In 2008, FNF acquired bankrupt title insurer LandAmerica Financial Group, which increased its market share to around 47% for a short time and regulators later forced FNF to divest some businesses in areas where there was a concentrated overlap.

Exhibit 3 shows that FNF's pretax margins are stronger than STC's more volatile and lower margins, providing an opportunity for FNF to integrate the STC businesses, which would benefit from FNF's industry-leading margins, underwriting expertise, aggressive expense oversight and technological capabilities. FNF expects the deal to boost earnings, partly through achieving at least $135 million in cost savings. Since title insurance is unique in that it results in low losses but high expenses (the opposite of property and casualty insurance), diligent expense management is critical to its success.

EXHIBIT 3
Comparison of FNF's and STC's pretax margins



Sources: SNL Financial, US Securities and Exchange filings and Moody's Investors Service

Sovereigns

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Pact for African Continental Free Trade Area is credit positive for continent and 44 participating countries

Last Wednesday, 44 of 55 African countries signed an agreement that will launch the African Continental Free Trade Area (AfCFTA). The agreement must be ratified at a national level and is due to take effect in 180 days. The free trade area, when it takes effect, will be credit positive for the continent and the participating African sovereigns because it will promote intra-African trade, which is more diversified than the continent's global exports and less reliant on the more volatile and less diversified raw materials market. However, one-fifth of the African countries, including Nigeria (B2 stable), one of the continent's largest economies, electing not to participate will temper the pace of progress and the pact's ultimate realisation of benefits.

Countries likely to benefit from the trade agreement include those with large manufacturing bases and relatively robust infrastructure, particularly access to electricity (see Exhibit 1). They include South Africa (Baa3 stable), Kenya (B2 stable), Egypt (B3 stable), Morocco (Ba1 positive), Namibia (Ba1 negative), Tunisia (B2 stable), Cote d'Iovire (Ba3 stable), Senegal (Ba3 stable) and Cameroon (B2 stable). In addition, Ethiopia (B1 stable), which has made significant progress in developing its industrial sector, also has the potential to gain further through rising intra-regional trade.

EXHIBIT 1
African countries with larger manufacturing bases and better access to electricity are more likely to benefit from further integration

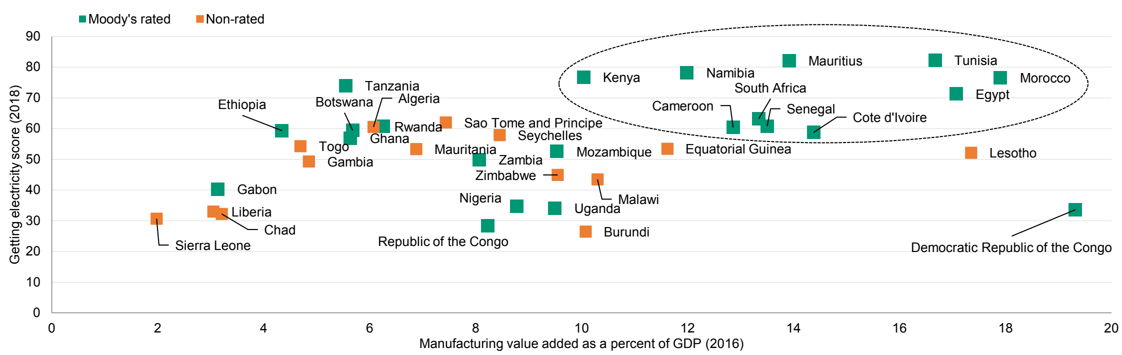


Exhibit based on latest available data.

Electricity score is based on World Bank data that is the simple average of four components of getting electricity: time, costs, procedures and reliability of supply. Higher scores mean better performance.

According to African Union, South Africa and Namibia did not sign AfCFTA, but did sign the Kigali Declaration establishing AfCFTA.

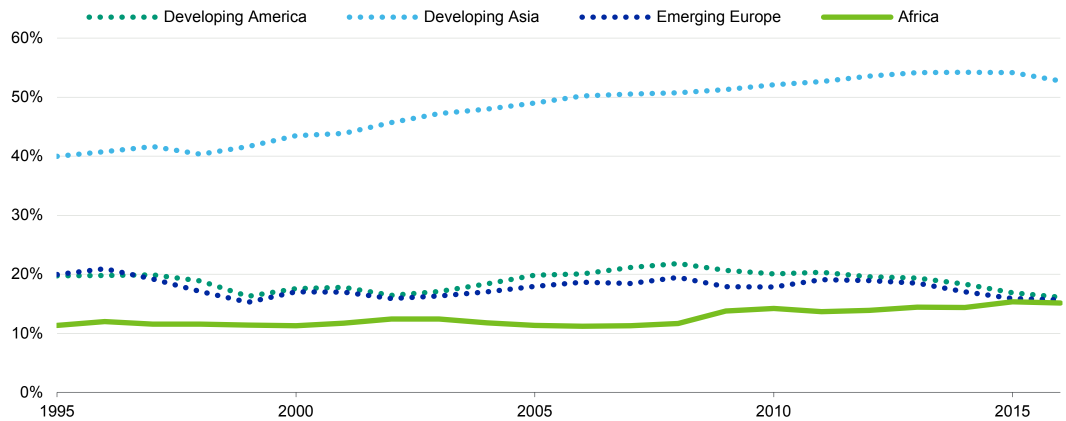
Sources: World Bank and Moody's Investors Service

Intra-African trade has increased in recent years to 15% of total trade from 11% in 2008, but remains below levels in other regions before the 2009 global recession (see Exhibit 2). African exports to the world are heavily oriented toward raw materials, but intra-regional exports contain more value-added goods than exports to the rest of the world. Manufactured goods accounted for 43% of intra-African exports between 2012 and 2016, compared with only around 20% of its exports globally.

EXHIBIT 2

Intra-African trade remains low, but is rising

Percent of intra-regional trade to total trade



Source: United Nations

An increase in intra-regional trade has the potential to curtail trade revenue volatility owing to the commodity price downturn, which has diminished trade revenue since 2015. Additionally, enhanced trade integration resulting in larger markets will also help countries attract foreign direct investment (FDI), with associated transfers of capital, skills and managerial know-how. During the past decades, the main motivation of FDI to Africa has been its natural resources, and to a lesser extent, the domestic market. Trade integration under AfCFTA would attract further market-seeking FDI as a means access new customers and export markets.

However, underdeveloped infrastructure and non-tariff barriers will constrain the initiative's implementation. According to World Economic Forum, African governments have spent an average of around $45 billion per year on infrastructure investment over the past decade, and yet around 85% of African countries in 2016 still had weak World Bank infrastructure index scores, or no scores at all.

Non-tariff barriers, such as corruption, ineffective customs documentation and broader procedural approaches impede exports and trade in Africa. Of the 24 African countries we rate, 16 have low or very low scores for institutional strength, one of four factors in our sovereign rating methodology. The World Bank estimates that the costs for intra-African trade are the highest among developing regions, and around 50% higher than in East Asia. According to the enterprise surveys by the World Bank, one-quarter of firms are deterred from engaging in foreign trade in Sub-Saharan Africa because of custom and trade regulations, which are the highest proportion globally. Nevertheless, the agreement provides incentives to address these obstacles.

US Public Finance

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New York City's tourism grows, driving a 4.4% sales tax revenue increase

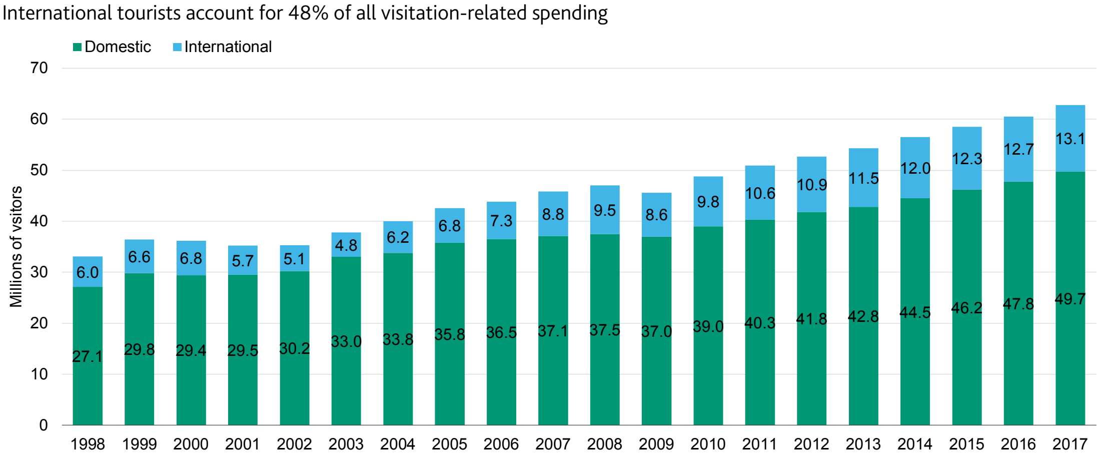
Last Tuesday, New York City (Aa2 stable) Mayor Bill de Blasio announced that a record 62.8 million tourists had visited the city in 2017, a 3.1% increase over 2016, which helped raise city sales tax revenue 4.4% last year versus 2016, a credit positive for the city.

Tourism benefits the city's bottom line, generating $4.2 billion in city tax revenue annually, mostly from its 4.5% general sales tax and 5.875% hotel room occupancy tax. Hotel room occupancy especially has contributed to tax growth: occupancy rates through October 2017 (the most recent data) were 92.3%, the highest since 2015, and the average daily room rate was $332, the highest since December 2016. These gains are also positive for state debt issued through the New York Convention Center Development Corporation (Aa3 stable) for improvements to the Jacobs Javits Convention Center secured by a $1.50 per room night fee.

Domestic visitors comprised 79% of the city's total tourist arrivals and international travelers 21%. But while international travelers are a smaller percentage of the total, they account for 48% of all visitation-related spending on lodging, food, entertainment, shopping and transportation. Foreign visitation could have dropped because of both tighter national immigration policy and a stronger dollar, but instead it increased. New York City's increase in international arrivals in 2017 contrasted with a 1.9% decline nationally in international arrivals from the top 20 countries through September, according to the most recent statistics from the US Commerce Department. In 2017, New York City's international visitation grew 3.1% over 2016 (comparable full-year national data are not yet available).

Over the past 20 years, tourism to New York City has increased nearly 90% and averaged 3.3% growth annually. It has declined only twice in that period; after the 2001 terrorist attacks and in 2009 during the recession (see exhibit). Leisure travel accounts for 79% of all trips to New York City, according to the city's tourism bureau, New York City & Company, driven both by vacationers visiting cultural attractions and people visiting friends and relatives. The remaining 21% of city visitation is for conventions, exhibitions and traditional business travel. The city's travel and tourism-related jobs generate $65 billion, or 8% of the city's $788 billion economy, according to New York City & Company.

Tourists say, "I love New York"
International tourists account for 48% of all visitation-related spending



Source: New York City & Company

Visitors from the UK comprised 10% of all foreign tourists, more than from any other country. Chinese visitors comprised 7.5% of foreign tourist arrivals, but have grown approximately 300% since 2010, according to US Commerce Department data.

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