China Eastern Airlines benefits from diversification efforts

by Liu Hanlei

When the RMB depreciated to an eight year low against the USD last week, the faster than expected depreciation caused concern among Chinese companies due to their large amounts of USD debt. The RMB depreciation reminded them of the surprise devaluation of RMB back in August 2015 and the shocking exchange rate loss reported by Chinese companies, including Chinese Eastern Airlines (CEA) - the second largest airline in China.

When CEA reported its FY2015 results, it managed to double its operating income to RMB 12.4bn compared to RMB 5.9bn in FY2014. Despite the good operating income results, partly supported by a 33% drop in fuel cost, CEA increased net income by 33% YoY to RMB 4.5bn. What caused the lower increase in net income was a stunning RMB 4.9bn foreign exchange loss, which exceeded the RMB 56mn foreign exchange losses in 1H 2015.

In 1H 2016, the company managed to narrow its foreign exchange losses to RMB 1.3bn and reported a 329% semi-annual gain in net income. The huge foreign exchange losses that incurred in 2H 2015 was related to the translation of CEA's foreign currency denominated borrowings and obligations under finance leases. Net interest expense during 2H2015 amounted to RMB 1.07bn (15% of 2H 2015's operating income) but foreign exchange loss amounted to a whopping RMB 4.9bn (72% of 2H 2015's operating income) which resulted in a huge dent in net income in 2H 2015. The RMI-CRI 1-Year Probability of Default (PD) for CEA rose to a high of 141bps on Feb 2016 from 24bps in Jul 2015. The PD subsequently fell to 25bps in Dec 2016.

Figure 1: RMI-CRI 1-Year PD for China Eastern Airlines. *Source: RMI-CRI*

	1H 2015	2H 2015	1H 2016
Revenue (RMB bn)	44.3	49.5	46.3
Operating Income (RMB bn)	4.4	6.79	7
Operating Margin (%)	12.9	13.88	15.45
Net Income (RMB bn)	3.5	0.97	3.2
Net Debt/Equity (%)	291.07	275.55	213.11
Cash Ratio	0.01	0.12	0.15

Table 1: Profitability and leverage ratios for CEA. *Source: Bloomberg*

According to Boeing, Chinese carriers have announced orders for about 780 planes with a combined price of USD 102bn in 2015. Aircraft and aircraft parts are big capital expenditures and transactions are typically denominated in USD. With the huge amount of USD spending required and CEA's confirmed order of 146 aircraft as of 1H 2016, CEA has to keep a certain portion of borrowing and finance leases in USD to facilitate the financing.

Looking at CEA's past 5 years of interest-bearing liabilities (borrowings and finance leases payable) in Figure 2 below, they are denominated mainly in USD. From its past financial reporting, CEA has recognized that the fluctuation in foreign exchange rates arising from the conversion of its foreign currency denominated interest-bearing liabilities would have a significant impact on the company's finance costs and thus profitability. The management noted that a 1% appreciation of USD against RMB would reduce its net income by RMB 600mn in 1H2015. During the record foreign exchange loss of RMB 4.9bn, CEA's USD exposure reached 73.3% of total interest bearing liabilities in 2015. Over the next 6 months, USD exposure decreased to 41.4% after the company sold RMB bonds at a record pace. As a result of a diversification in its interest-bearing liabilities, the impact of FX movements on net income has declined, which is reflected by a smaller foreign exchange loss in 1H 2016.

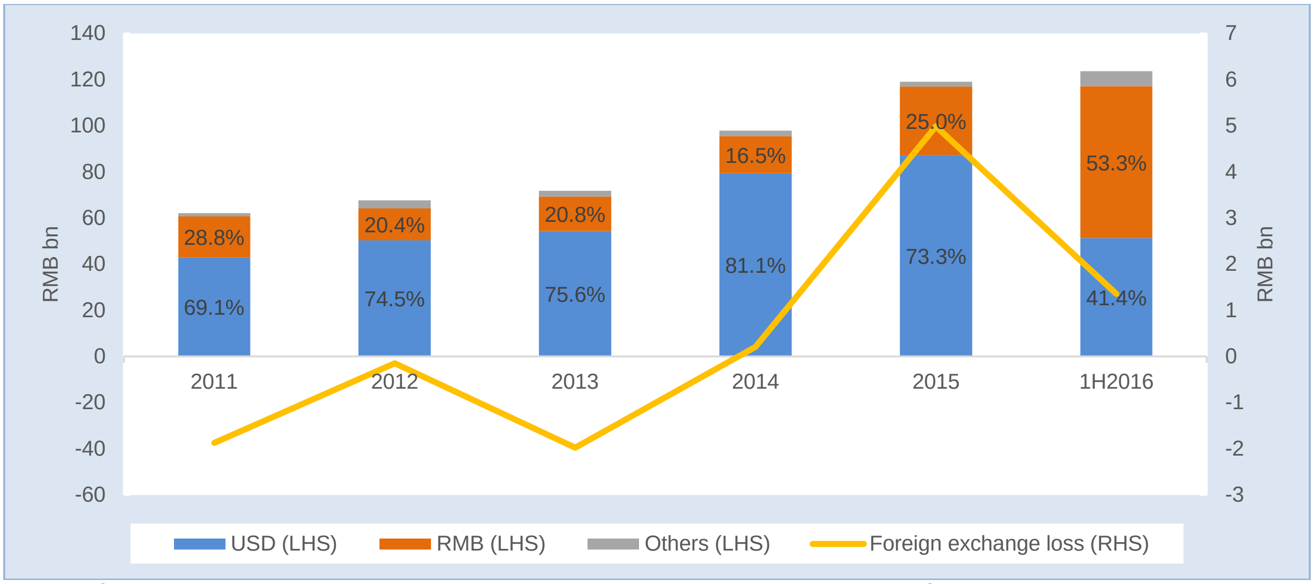

Figure 2: CEA's interest-bearing liabilities profile and foreign exchange loss. *Source: Bloomberg, CEA's annual reports*
Note: negative foreign exchange loss means foreign exchange gain

Looking forward, not only has CEA diversified its debt, the airline also tried to improve its balance sheet by reducing its net debt to equity ratio to 213% in 1H 2016. Its cash ratio has also increased to 0.15 from 0.01 in 1H 2015. CEA beefed up its capital by raising RMB 8.55bn in a private sale of shares to a group of investors including China's biggest online travel agency Ctrip in Jun 2016. In Dec 2016, CEA announced plans to sell its freighter operator, China Cargo Airlines for RMB 2.4bn. The sale will allow CEA to concentrate on its passenger service business, which is deemed more lucrative as the increasing demand of China tourists to travel regionally and internationally will continue to spur air travel business.

Based on statistics from China's Outbound Tourism Research Institute, China has notched to a record of 101.5 million border-crossings for the first three quarters of 2016. Outbound tourism to countries other than Hong Kong, Macau and Taiwan also recorded an impressive 14.5% YoY growth rate. For 1H 2016, the overall number of passengers that CEA carried increased 9% YoY with international routes increasing by 17.8% YoY. With the stronger demand from Chinese tourists to international destinations, CEA needs to remain competitive to compete in the long-haul routes market. To capture future opportunities, it has entered into agreement to take delivery of 15 B787-9 and 20 A350-900 airplanes for 2018-2022.

As seen in the recent episode of foreign exchange losses from its interest-bearing liabilities, CEA highlighted the importance in managing the foreign currency risk in debts. Given that the RMB has declined against the USD over the past few months and is expected by analysts to weaken further, the high debt ratio maintained by CEA is still of concern but the risk has abated due to its diversification efforts.

Credit News

Europe's bank stress-test star is focus of buyback speculation

Jan 8. Norway's biggest bank, DNB ASA, topped the European Banking Authority's resilience score as its capital reserves were more than sufficient and were hardly affected in the stress tests' "adverse" situation. Analysts are estimating that DNB will be using the excess funds to buy back its own shares thus attracting investor interest. Norway's regulator has always been strict in applying tougher capital rules than other countries and this puts DNB at a better capital position. However, Norway's regulators might raise the counter-cyclical buffer to cool the overheated housing market, leaving little room for shareholder rewards. (Bloomberg)

Triyards Q1 profit tumbles 66% with higher revenue offset by lower margins

Jan 6. Triyards Holdings, an integrated provider for the offshore oil and gas industry, reported a 66% decline in first quarter net profit to USD 2.1mn for USD 6.2mn a year ago despite higher revenue. In a filing with the Singapore Exchange, Triyards stated that the decrease in gross profit margins was due to a different mix of projects as well as a competitive market environment. Triyards also stated that it has successfully diversified its clientele base and expanded its product offerings beyond oil and gas assets, however, its primary business segment remains focused on creating assets for the full oil and gas value chain. (Straits Times)

Bankruptcy filing deepens woes for cocoa firm hit by Brexit

Jan 5. The German and US units of Transmar Group, a supplier of cocoa beans, butter and powder to the confectionary industry have filed for bankruptcy in their respective jurisdictions. The company's cash flow problems resulted from large losses in unhedged transactions in cocoa contracts which were magnified when cocoa prices turned against the firm. Cocoa contract prices reached a six year high in July last year but subsequently declined as West African farmers increased production. As of Dec 31, Transmar owed more than USD 360mn to creditors and USD 8.7mn to Amerra Capital Management LLC. (Business Times)

Sugar industry seeks debt restructuring, loans rescheduling

Jan 4. India's sugar industry has sought the government to restructure debt and extend interest subvention on soft loans for another three years as the debt burden amounts to INR 50,000 crore. A representation comprising of private and cooperative sugar mills bodies, The Indian Sugar Mills Association (ISMA) and National Federation of Cooperative Sugar Factories, had been made to the Prime Minister's Office (PMO) and Finance Minister Arun Jaitley. In a separate meeting with the Finance Minister, ISMA president mentioned that the sugar industry is "still not fully out of its problems". The ISMA also stated that "the government and RBI should slightly modify the threshold limit under the S4A scheme of debt restructuring from INR 500 crore to IND 100 crore". (Business Standard)

China Inc.'s large Dollar debts fuel Beijing's efforts to curb Yuan plunge

Jan 3. Chinese authorities are tightening capital controls to prevent the Yuan from falling too quickly as many Chinese companies have large foreign currency exposures. Companies such as Air China and China Southern Airlines earn revenue in Chinese currency but have billions of US dollar denominated debt. China's regulators are scrutinizing individual foreign currency transactions as money has been leaving the country at a faster pace in recent months. According to estimates by the Goldman Sachs Group, China recorded a net outflow of USD 69.2bn in November which exceeded the monthly outflow of USD 50bn since June. (WSJ)

China reserves slumped USD 320bn last year as Yuan tumbled (Bloomberg)

US unit of Transmar Group files for bankruptcy protection (WSJ)

Brazilian bankruptcy filings at 11-year high (WSJ)

Regulatory Updates

Smaller companies fear threat from new financial regulation

Jan 9. Brokers have warned that new European financial regulations risk damaging small-mid cap businesses by throttling coverage of them in research provided to investors. Previously, the research fees are bundled into the cost of brokers' overall services to clients alongside the execution of trades, a business custom that will be changed under Mifid II, Europe's second Markets in Financial Instruments Directive, when it comes into force in January 2018. Asset managers will have to be clear that they are using investors' money to pay for so-called "sell-side" research, or cover the costs themselves. Under Mifid II, free research that asset managers receive from brokers would be considered an "inducement to trade". The new regulation is expected to adversely affect many small and medium-sized listed companies that rely on these notes to promote their stocks could be cut off. (FT)

Basel postpones bank reform vote amid policy differences

Jan 3. According to the Basel Committee on Banking Supervision, a meeting of the world's top bank supervisors and central bankers to consider a contentious reforms package has been postponed. The meeting, which was expected to result in the signing of a series of reforms that would make avoiding of the Basel III capital requirements tougher for banks, was delayed as key parts of the reforms are still not agreed. The main sticking point between supervisors in the US and Europe is the output floor that limit the prowess of banks to use their own models to calculate the riskiness of lending. The decision to do further work on the proposal was welcomed by Michael Lever, the head of prudential regulation at the Association for Financial Markets in Europe (AFME), which represents the biggest banks and other wholesale markets participants. (FT)

Enough policy tools, now it's time for China to refine its approach on sorting bad debt (SCMP)

Top US oil industry group lobbies Trump for lighter regulation (FT)

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Contributing Editor: Dexter Tan