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Weekly Credit Brief Oct 10 - Oct 16

Misplaced bets on ethanol weaken the delicate capital structure of Biosev SA

By Lu Chang

Biosev SA, the second largest sugarcane processor in the world by crushing capacity, is running into financial difficulties after recording consecutive periods of losses. The share price of Biosev has been down 34% year to date and ongoing concerns about financial distress emerged after the company disclosed its attempt to raise new capital for the continual of its operations. However, the current high leverage of Biosev is preventing it from raising the much-needed capital. On top of its delicate capital structure, misplaced bets on ethanol pushed Biosev into further financial troubles as the company realized losses on ethanol trading contracts. The future of Biosev has become more uncertain with sugar and ethanol prices expected to remain highly volatile, threatening future earnings of the company.

As a subsidiary of Louis Dreyfus Company (LDC), Biosev was established in 2009 following the merger of LDC Bioenergia and Satelisa Vale. The company had undergone an initial public offering in 2013 with its main stakeholder as Sugar Holding B.V. an intermediary holding company of LDC. Biosev currently operates 355,000 hectares of sugarcane plantation in Brazil with 12 mills producing sugar and sugar-related products such as ethanol and molasses.

Due to a surge in domestic ethanol prices in Brazil during 2016, importing ethanol for resale in Brazil became a profitable venture for ethanol traders like Biosev SA. Domestic stockpile of ethanol had been depleting and ethanol prices started to surge towards the end of 2016. Biosev saw the opportunity to profit by taking advantage of the cheap ethanol imports from the US to be resold in Brazil where ethanol prices were much higher. However, Biosev was not the only company to seize the opportunity. Most of the other ethanol traders also placed their bets on the surging ethanol prices, resulting in a wave of US ethanol imports that flooded the market. Brazil's ethanol imports hit an all-time high of 559.4 million liters in Q2 2017, with almost all imports coming from the US.

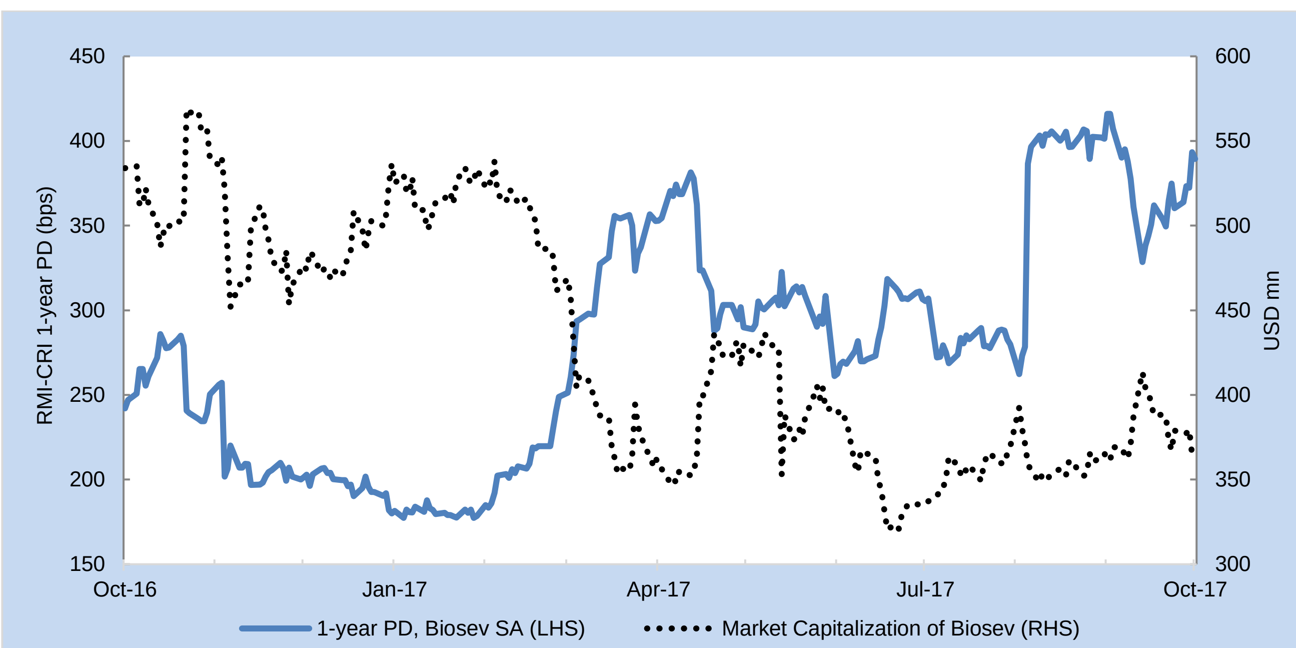

Figure 1: RMI-CRI 1-year Probability of Default and Market Capitalization of Biosev SA, *Source: RMI-CRI, Bloomberg*

In the first half of 2017, ethanol imports into Brazil increased more than 300% compared to the same period last year. The sharp increase in supply caused ethanol prices to plunge by more than 20% with demand remaining roughly constant. As a result, many ethanol traders suffered substantial losses with some being forced to wash out current import contracts to cut loss. The report of losses by Biosev induced a sell-off of its shares in February, resulting in a significant decline of its market capitalization. The RMI-CRI Probability of Default (PD) for the corresponding period hit a high of 381.5 bps (Figure 1) with the decrease of the Distance-To-Default (DTD) variable.

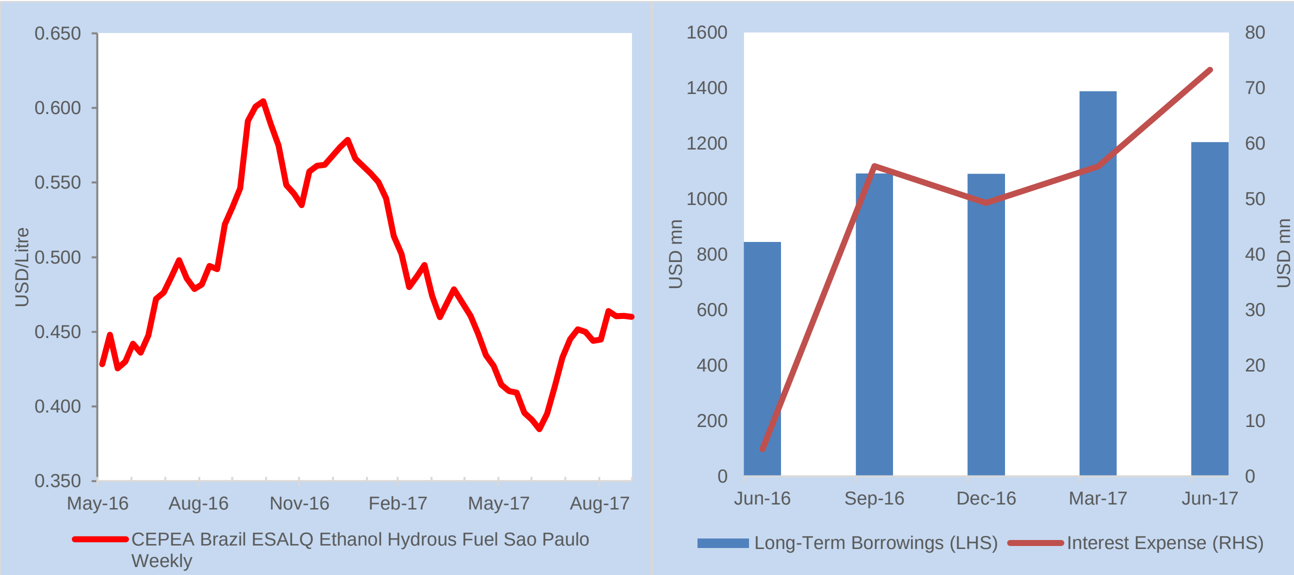

Figure 2 & 3: Brazil ESALQ Ethanol Price Index, Long-Term Debt and Interest Expense Movement of Biosev SA, *Source: Bloomberg*

	Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017
CAPEX (USD mn)	65.39	78.78	98.34	152.62	79.16
Net Income/Losses (USD mn)	-100.76	7.25	12.97	-99.67	-179.49

Table 1: Capital Expenditures and Net Income/Losses of Biosev in recent quarters, *Source: Bloomberg*

Even before the fall of ethanol prices, Biosev had been struggling with a growing debt burden. Due to the capital intensive nature of the sugar processing industry, investments into replantation is necessary to keep up with production volumes in the future. Biosev had previously funded these investments through raising debt. However, rising debt levels had resulted in the ballooning of Biosev's interest expense (Figure 2 & 3) which undermined its profitability (Table 1). Losses due to bets on ethanol only made the situation worse as it deprives Biosev of the much-needed earnings to be invested for sugarcane replantation.

As a response to its growing interest expenses, Biosev is looking to trim its debt through an equity offering or a bond issuance. Under current conditions, the options of Biosev are largely limited to an equity offering as previous defaults by other ethanol producers have weakened investor confidence towards companies in this sector. However, raising capital through an equity offering remains a challenging task due to the heavy debt load and uncertain prospects of the company. Without the necessary capital for reinvestment, Biosev will not be able to keep up production volumes, hampering the future earnings of the company.

As the parent of Biosev, Louis Dreyfus Company (LDC) has been extending "cash-for-crop" loans to the company in view of its worsening credit position. Due to the heavy capital expenditures (Table 1) spent on re-investments into milling units, Biosev is not expected to generate any free cashflow in the upcoming three years. Although there have been attempts by Biosev to strengthen its capital structure through deleveraging and extension of its debt maturity, it still very much depends on its parent for solutions to its deteriorating debt problem.

The future of Biosev lies in its ability to generate sufficient profits to continue its operations and improve its current credit position. Battered by the range of issues explained above, Biosev is in urgent need of a turnaround strategy to reverse out of its current precarious state.

Credit News

World's top central bankers betting inflation will soon accelerate

Oct 16. The world's top central bankers signaled that they would gradually tighten monetary policy as they surmised that the global economic expansion would translate into faster inflation. The Federal Reserve and ECB is confident that the inflation will soon increase while the United Kingdom's inflation is already above target. Economists from JPMorgan Chase & Co also forecast that global headline inflation will reach almost 3% in the fourth quarter, the fastest in over six years. Fed funds futures currently suggest a 74% chance that the Fed will lift its rate again in December. (Straits Times)

China new yuan loans rise more than expected in September

Oct 14. Stimulated by demands from home buyers and companies, Chinese banks extended more loans than expected in September, even as the government tightened policies to reduce its years-long addiction to cheap debt. According to the third-quarter economic data, both bank lending and total social financing, a broad measure of credit and liquidity, have hit a high point this year. Short-term loans increased by RMB 153tn in the third quarter, almost three times higher than a year-ago period. Chinese authorities are trying to find a way to contain risker types of financing and slow the growing debt without stunning economic growth, but the results seemed to be mixed as credit growth remained elevated. Analysts are expecting China to accelerate its implementation of reforms after the Communist Party Congress. (Reuters)

Apple, Disney Canadian bond debuts were sparked by local demand

Oct 13. Apple Inc. and Walt Disney Co. sold CAD 2.5bn and CAD 1.25bn Canadian dollar bonds respectively this year after understanding that the demand for these securities is high. These two bond offerings are of the biggest Canadian bond sales this year, which drove this year's issuance in the Canadian bond market to almost CAD 14bn. Besides Apple and Disney, companies like McDonald's Corp., United Parcel Service Inc. and PepsiCo Inc. also issued Canadian dollar denominated bonds for the first time. The surge in Maple bond issuance has been sparked by several factors. For instance, pricing has become attractive from a currency swap perspective, and Canadian banks have left space to fill in the local market as they increasingly seek funding abroad. (Bloomberg)

MAS keeps Singdollar policy unchanged even as economic growth surges to 3-year high

Oct 13. The Monetary Authority of Singapore (MAS) kept its "neutral" policy of zero appreciation against the currencies of Singapore's key trading partners. This came as the Singapore economy grew by 4.6% in the third quarter as compared with the same period a year earlier, the fastest pace in more than three years. In its latest policy statement, the MAS struck a more upbeat tone despite keeping its policy unchanged, and noted that the Singapore economy performed "slightly better than expected" since its last policy review in April 2017. Moving forward, the MAS indicated that for the rest of the year and into 2018, Singapore's economic growth is expected to remain firm but could moderate slightly as the global economic recovery enters a more mature phase. Core inflation will also inch up next year, coming in at around 1.5% this year and an average of 1% - 2% next year. (Straits Times)

IMF warns of 'vulnerabilities' that could derail global recovery

Oct 11. The International Monetary Fund (IMF) has warned that the buoyant global economy masks longer-term risks, including a USD 135tn debt pile in G20 nations that may cause difficulty for companies and consumers to service. If left unattended, these vulnerabilities under the surface could derail the global recovery and lead to a crisis that cause equity prices to fall by 15% and cuts global output by 1.7%. Rising debt in most G20 countries have lead to higher debt service ratios causing greater financial stress. Among the countries, the US and China each accounted for about a third of the USD 80tn increase in debt since 2006. The world's largest and important banks and biggest insurers were also in focus as about half of the major banks still generate return on equity below 8% and expected to generate unsustainable returns in 2019. (FT)

Sagging growth complicates India's bad-debt clean up (Bloomberg)

US bank tables start to turn as Bank of America rebounds (FT)

Provident Financial looks to revive doorstep lending business (FT)

Regulatory Updates

China's Zhou warns corporate debt too high, urges fiscal reform

Oct 16. People's Bank of China Governor Zhou Xiaochuan has warned that corporate debt level for Chinese companies is too high and the central bank needs to continue to put more efforts to deleverage and maintain financial stability. Some of China's corporate debt includes borrowing from financing vehicles owned by local governments, which would reduce the corporate borrowing level to about 120% instead of the official figure of 160% of GDP. The government debt would then rise to 70% instead of the official figure of 36%. The central bank has also reduce activities in shadow banking as part of the government's efforts to reduce financial risk taking. However, Mr Zhou sounded caution on the vulnerability of the asset management business, as the regulation standards in the industry are not consistent across the three regulators. (Business Times)

ECB to consider cutting QE purchases in half next year

Oct 13. The European Central Bank (ECB) is considering cutting their monthly bond purchases in January by at least half to EUR 30bn a month from the current pace of EUR 60bn, and keeping the program active for at least nine months. Some ECB governors favor such reining in of support, in view of the recent robust economic growth. Others, however, are concerned that inflation remains too weak. Nonetheless, the ECB pledges that if "the outlook becomes less favorable, or if financial conditions become inconsistent with further progress toward a sustained adjustment in the path of inflation, the Governing Council stands ready to increase the program in terms of size and/or duration." (Bloomberg)

Regulators warn retail traders against cryptocurrencies (FT)

Ministers plan reforms to prevent repeat of Monarch collapse (The Guardian)

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