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Grocers' price war does not bode well for Kroger

by Liu Hanlei

Over the past 3 quarters, Kroger Co. lost 45% of its market capitalization as it fell to USD 17.8bn at the end of Sep 2017. A probable reason for Kroger's market selloff is its relatively weaker financial standing to meet headwinds in the grocery sector. As the US retail food prices registered their first annual drop in 50 years for the year of 2016 due to lower oil and grain prices, Kroger's CEO attributed the fall in margins to deflationary food prices. The woes in the grocery sector are further exacerbated by a price war that is weighing on the grocers' already thin margins. Moreover, new entrants to the already crowded grocery sector pressure incumbents.

Aldi and new entrant, Lidl, discount chains from Germany, are employing their low cost strategies in the US after successfully capturing market share in the Europe and UK. Lidl has opened their first store in June 2017 and Aldi has announced to spend USD 3.4bn to add 900 outlets in the next 5 years and a further USD 1.6bn on revamping existing stores. Bain, a consultancy firm, predicts that sales of Aldi and Lidl's discount grocery business will grow as much as 10% annually through 2020, approximately five times higher than traditional grocers such as Kroger.

In addition, Amazon's acquisition of Whole Foods, a competitor of Kroger, in Aug 2017 may further shake up the grocery sector. Amazon can potentially leverage on its economies of scale and integrate with its e-commerce expertise to gain market share in the grocery sector. Based on the sector's market share data in 2016, Walmart occupies the biggest share at 14.46% as 50% of its revenue comes from groceries. Meanwhile, Kroger is number two with 7.17% market share and Whole Foods occupies 1.21%. Analysts are expecting that the combined Amazon and Whole Foods to gain higher market share over the next few quarters. As a first step, Amazon cut prices at Whole Foods on a number of staples. The price cutting strategy seems to be effective, as according to Thasos Group, a data provider, visits to Whole Foods have jumped 17% following the price cuts. 24% of the increased traffic to Whole Foods are regular customers from Walmart and 16% from Kroger's. The aggressive price cut strategies by relatively new entrants may spell trouble for the incumbents as the price war for market share intensifies.

Figure 1 below exhibits a similar increasing trend both in the 5 year senior unsecured Credit Default Swap (CDS) spread for Kroger and the RMI-CRI 5-year Actuarial Spread (AS) in the past few months. The RMI-CRI AS is the annualized premium that is needed to compensate the default risk on an actuarial basis as measured by the RMI-CRI Probability of Default (PD). It is equivalent to the physical CDS par spread and is an alternative measure of credit risk, available for over 66,000 companies globally. The data presented is based on a recovery rate of 40%, the ISDA standard recovery rate. Unlike CDS, the RMI-CRI AS is a pure measure of default risk, and is not influenced by risk premium and market liquidity. In Table 1, the RMI-CRI AS is particularly useful for Sprouts Farmers Market to compare its credit profile as it does not have a CDS spread (availability for listed companies is less than 500). Comparing the RMI-CRI 5-year AS across Walmart, Target and Sprouts Farmers Market, it highlights the relatively weaker credit profile of Kroger.

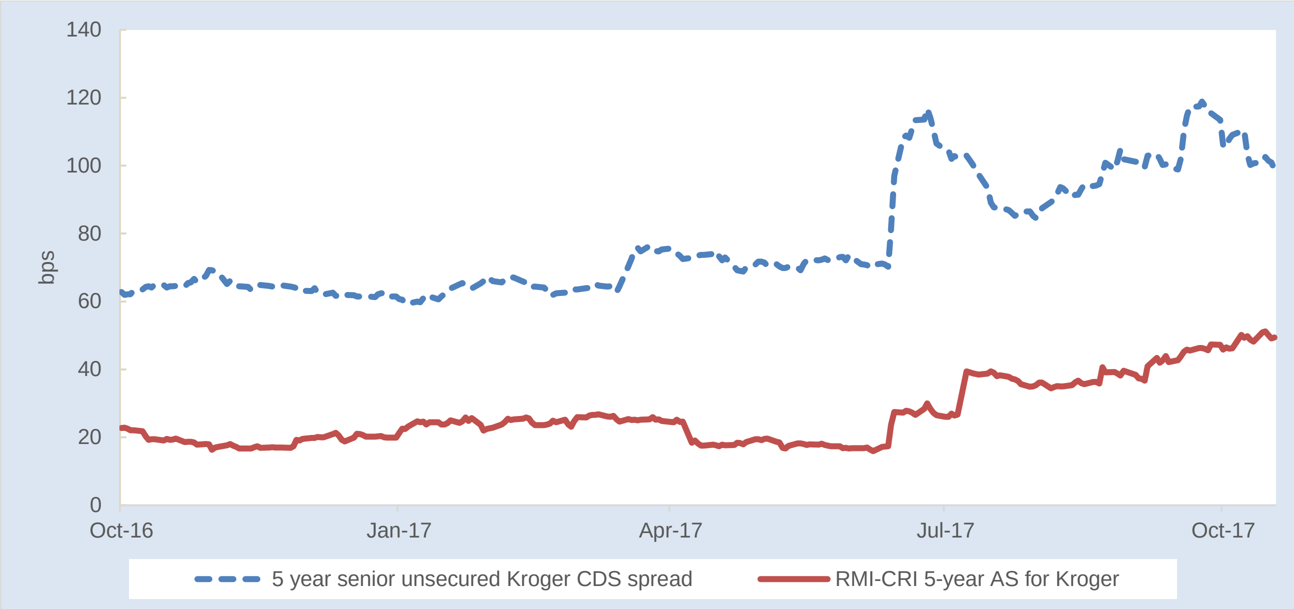

Figure 1: 5 year senior unsecured Kroger CDS spread and Kroger's RMI-CRI 5-year AS as of 20 Oct 2017. Note: The RMI-CRI AS is computed based on a recovery rate of 40%. *Source: RMI-CRI, Bloomberg & CBIN*

	Walmart	Target	Sprouts Farmers Market
5 year senior unsecured CDS spread (bps)	28.1	51.3	N.A.
RMI-CRI 5-year AS (bps)	4.26	14.84	19.21

Table 1: 5 year senior unsecured CDS spread for Kroger's competitors and RMI-CRI 5-year AS as of 20 Oct 2017. Note: The RMI-CRI AS is based on a recovery rate of 40%, ISDA standard recover rate. *Source: RMI-CRI, Bloomberg & CBIN*

The higher RMI-CRI 5-year AS for Kroger could be explained by its relative weakness in its operating and financial standing. Same store sales and operating margin are key financial metrics to measure the profitability of a grocer. Facing stronger competition, Kroger's same store sales figures have been weak, falling from Q3 2016 to Q1 2017 and only improving in Q2 2017 to 0.7%. The same store sales figures are lower than its competitors' such as Walmart which achieved positive same store sales for the past quarters. Kroger's low operating margin among its competitors and its very high leverage do not put it in a good position in the current competitive environment (see Figure 2 & 3). Kroger built up its high leverage due to its slew of acquisitions over the past years and it has a low operating margin due to Kroger's input cost falling less than its retail pricing for the past six quarters in a row. In Q2 2017, the input cost of Kroger increased by 1% while retail pricing dropped 0.5%, though retail pricing has improved from a 1.5% drop in Q1 2017.

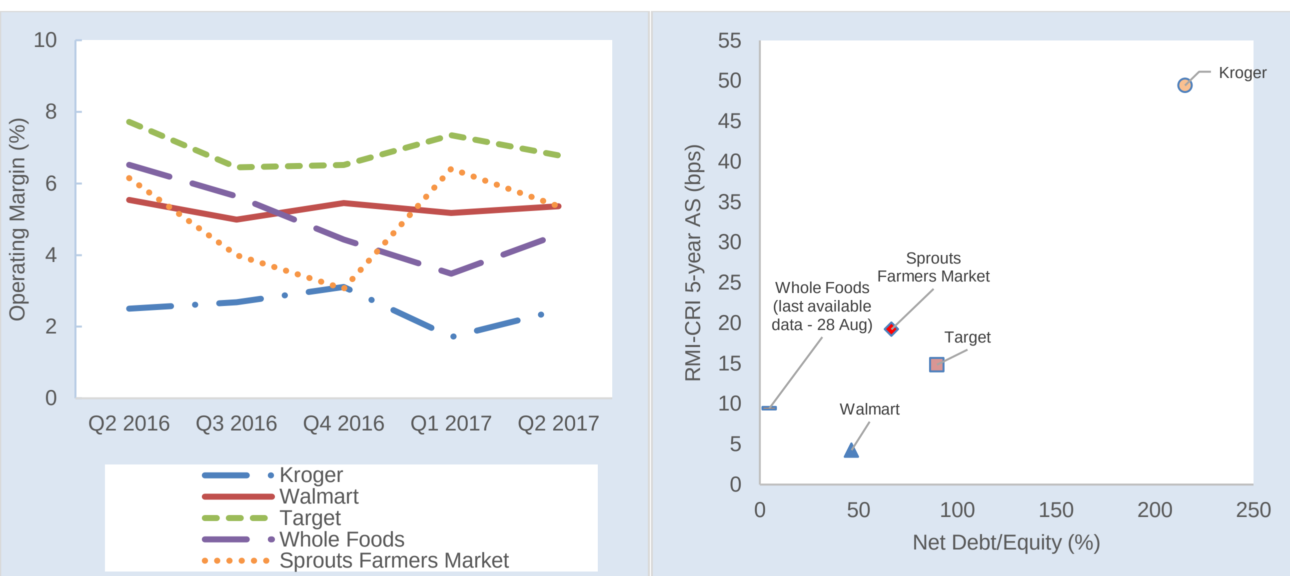

Figure 2 & 3: Operating margins of Kroger and 4 competitors (left panel); RMI-CRI 5-year AS of Kroger and 4 competitors as of 20 Oct 2017 and net debt to equity ratio reported in Q2 2017. Note: The RMI-CRI AS is based on a recovery rate of 40%, ISDA standard recover rate. *Source: RMI-CRI, Bloomberg & Company filings*

Kroger's high leverage and relatively lower operating margins put itself in a tight spot given the headwinds in the industry. To keep up with competition, Kroger has been continuously investing. Over the next 3 years, it is expanding its technology to optimize its inventory system, pricing analytics and revamping its 2800 stores, ultimately to improve customers' experience. Given that its same store sales has shown a slight pick-up in Q2 2017, Kroger still stands some chance to improve its performance in the coming quarters in this competitive industry.

Credit News

Default rates rising for P2P lendings

Oct 23. Default rates for peer-to-peer loans have risen at an alarming rate in Korea. The average default rate, which counts loans unpaid between 30 days and 90 days, reached 2.99% in September and nearly tripled from 1.04% a month earlier. Officials indicated that the jump in defaults is highly resulted from the business circumstances of Fundu, one of the top-10 P2P companies, whose default rate was zero at the end of August but leaped to 77.2% as of October 20. In order to extend the loan intervals to meet P2P investors' demands, lenders like Fundu have been raising funds in consecutive cycles. However, such practice was restricted after government recommended a ceiling for an individual's investment in a single firm in May. Other P2P lenders, especially those service real estate lendings, are also reporting higher default rates. (Korea Herald)

UK companies step up battle to rein in pension costs

Oct 22. As retirement payouts continue to grow, British companies are looking for ways to cut their pension bills. There are currently 11mn members in private sector defined pension plans, which promise to pay a secure retirement income for life. However, the collective pension deficit of FTSE 350 companies has now reached GBP 65bn, with many worried about future payouts. In response, British firms intend to take legal action or begin negotiations with retirement scheme trustees to amend current schemes. One such proposal is to rebase future increases for pensioners on RPI instead of CPI. This move is estimated to lower the combined deficit of private sector defined benefit plans by GBP 175bn. However, analysts anticipate resistance against the move as it will result in a drop in the lifetime income of pensioners. (FT)

Concordia plans restructuring after missing interest payment

Oct 20. Concordia International Corp. is pursuing a plan under the Canada Business Corporations Act (CBCA) to restructure its finances and cut borrowings by at least USD 2bn after skipping an USD 26mn interest payment on some unsecured bonds on October 16. The CBCA allows companies to restructure out of court, although the plans require final court approval. Analysts point out that the main catalyst for the restructuring was excessive debt and failure to control cash flow. Concordia took on USD 3.7bn in debt during an international acquisition spree and has not posted an annual profit since 2014, incurring losses that is topping USD 1bn so far this year. According to Concordia's CEO, Allan Oberman, "the decision to use the CBCA process to achieve our financial goals was a strategic one that ensure we achieve the best possible transaction for our company, employees, suppliers, customers and other business partners". (Bloomberg)

Greece's Eurobank to sell debt eligible for purchase by ECB

Oct 19. Greece's Eurobank is tapping the bond market for the first time in more than three years, as the broader Greek financial sector returns to international markets following a multi-year hiatus. The bank has hired a consortium of investment banks to sell a three-year covered bond as early as next week. Covered bonds are secured against a pool of loans, typically mortgages, to provide investors with additional security in the case of default, and are immune to "bail-in" under new Brussels laws designed to handle bank failure in Europe. According to bankers, while Greek government bonds are not eligible for the ECB's sovereign debt purchases, the country's covered bonds could benefit from central bank demand, as the central bank can buy covered bonds in both primary and secondary markets. (FT)

Hawaii's Island Air files for bankruptcy
Oct 17. Hawaii's Island Air filed for Chapter 11 in Honolulu after failing to settle legal troubles that threatened to ground its aircraft. The bankruptcy filing freezes litigation and prevents creditors from sizing assets, allowing the company to work out a plan to reorganize its debts and continue normal operations. The airline's CEO believes that Island Air would be irreparably harmed without bankruptcy protection. "Once we have completed the reorganization process, Island Air expects to emerge as a stronger airline with a solid financial structure," he said. As such, the company is seeking court permission for access of its bank account to pay its more than 400 employees and honor customer obligations. (WSJ)

Noble Group to sell oil liquids business to Vitol, flags big third quarter loss (Reuters)

Debt collector Cabot plans to float on London Stock Exchange (FT)

VidAngel files for bankruptcy amid fight with movie studios (WSJ)

Regulatory Updates

Banks plan to shift APAC trading books from London to Hong Kong

Oct 23. Major investment banks are talking to regulators about routing their Asia-Pacific trading activities through Hong Kong instead of London. Banks used to book much of their global markets business through London because it is more capital efficient to centralize activity in a single entity and some regional regulators lack the sophistication to oversee complex markets business. However, London's status as a global booking center was hobbled by the UK's decision to quit the EU. With the trend of shifting APAC trading activities to Asia, bankers have felt pressure from global regulators to hold their risks closer to their origination, and that more regulators are developing regimes to make regional booking centers viable. (FT)

China's USD 150bn debt-for-equity swap shows signs of fizzling

Oct 19. China's plan to swap more than SGD 150bn in corporate debt with equity from banks and other investors has moved forward far slower than expected as banks and companies question the benefits of such deals. Banks have so far executed 13.7% of the total swap amount that was announced when the program was launched. In addition, the delivered size of the equity investments has been just a fraction of the originally announced deals in some transactions. While China's premier Li Keqiang championed the swap plan as a means of helping state-owned firms survive cyclical downturns in troubled industries, some analysts suspect it would exacerbate moral hazard, allowing failing companies to escape their debts too easily. (FT)

ANZ Bank settles with regulator on rate-rigging case (Bloomberg)

Simplified rules for Singapore VC managers take effect on Oct 20 (Business Times)

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Contributing Editor: Victor Liu