Credit Research Initiative

Weekly Credit Brief September 30 - October 06

Feature of the week

US for-profit schools need to be bigger and better in order to survive

by Justin Hsiao

Public-listed schools in the US like Education Management Corp, ITT Education Services Inc., and Corinthian College Inc. are facing challenges and struggling to survive in the education service industry. Companies are witnessing falling revenues due to fewer enrollments and increasing number of lawsuits arising from misrepresentation of marketing materials and predatory lending to students. Education institutions are also having problems in filing their financial reports on time to their respective stock exchanges.

Unlike the well-known schools that have large coffers in their endowment funds, these schools have to depend on student enrollments and school fees to remain viable. Table 1 shows the biggest market capitalization (Market cap) companies in the education service industry. Listed firms like Apollo, DeVry, and Grand Canyon, had better profits and longer histories in running schools. On the contrary, smaller companies had lower earnings due to higher operating costs.

Company Name	Market Cap (as of Oct 6 2014)	Trailing 12 mth Company Revenue (as of Dec 2013)	Trailing 12 mth Net Income (as of Dec 2013)
Apollo Education Group Inc.	2,839	3,483	214
DeVry Education Group Inc.	2,820	1,926	66
Grand Canyon Education Inc.	1,918	598	89
Education Management Corp	110	2,408	-271
ITT Education Services Inc.	101	1,070	59
Corinthian College Inc.	8.3	1,508	-18

Table 1: Profile of big & small market cap proprietary schools. Figures expressed in USD mn. Source: *Bloomberg, company reports*

Figure 1 demonstrates the RMI 1-year Probability of Defaults (RMI 1-year PDs) for the top three proprietary schools in terms of market cap and three troubled proprietary schools. Apparently, the trends between Figure 1a and 1b are completely different. For the top market cap companies, their RMI 1-year PDs are getting close to zero from the beginning of 2013. On the other hand, the troubled companies' PDs significantly increased in 2014. Corinthian College Inc., among all, has the worst RMI 1-year PD, which reached 6,526bps on Sep 30, 2014.

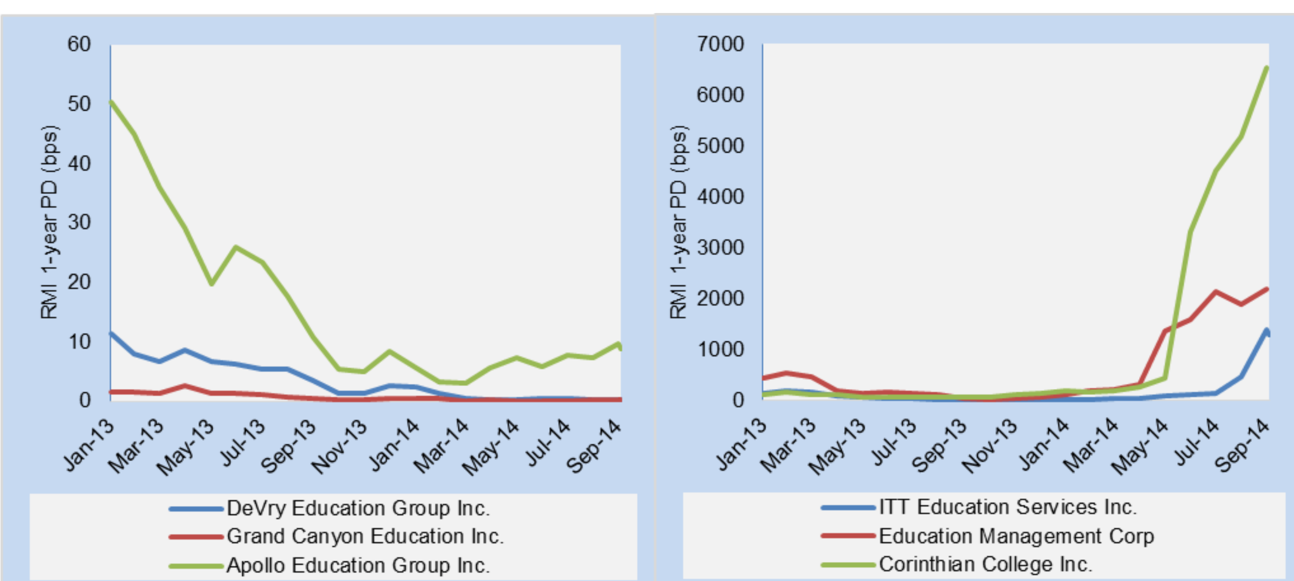

Figure 1a – 1b: RMI 1-year PD for the largest (1a, LHS) and most troubled companies (1b, RHS). *Source: Risk Management Institute*

Total student loan debt in the US reached USD 1.2tn in Q2 2014 and is now the second largest sector of household debt after mortgage loans, USD 8.1tn in Q2 2014. According to Figure 2a, student loans have grown 1.6 times since Q4 2008 and have the highest growth ratio among all other consumer debts. When a student graduated from school or dropped below half-time enrolment, he/she doesn't have to begin repaying most of federal student loans until grace period ends, which is usually six-month. If the student enters repayment and defaults within the next three fiscal years, he/she will be classified as a defaulter. Findings made by the New York Federal Reserve Bank show that only about 56% of borrowers are making payments. That means an astonishing 44% of the borrowers are not repaying their loans. Just to gain some perspective only about 10% of borrowers fell behind on their mortgage payment during the recent mortgage housing crisis. In addition, the overall default rate for student loan in fiscal 2011 was 13.7%. The default rate's breakdown by different education sectors, in Figure 2b shows that for-profit colleges represent about 12% of the total higher education enrollment, but their cohort default rate accounts for about 44% of all student loans and almost half of defaults on those loans, according to the Education Department. In this sense, student loan is like a toxic asset to Federal Government, and the proprietary school loan is even worse in terms of default rate.

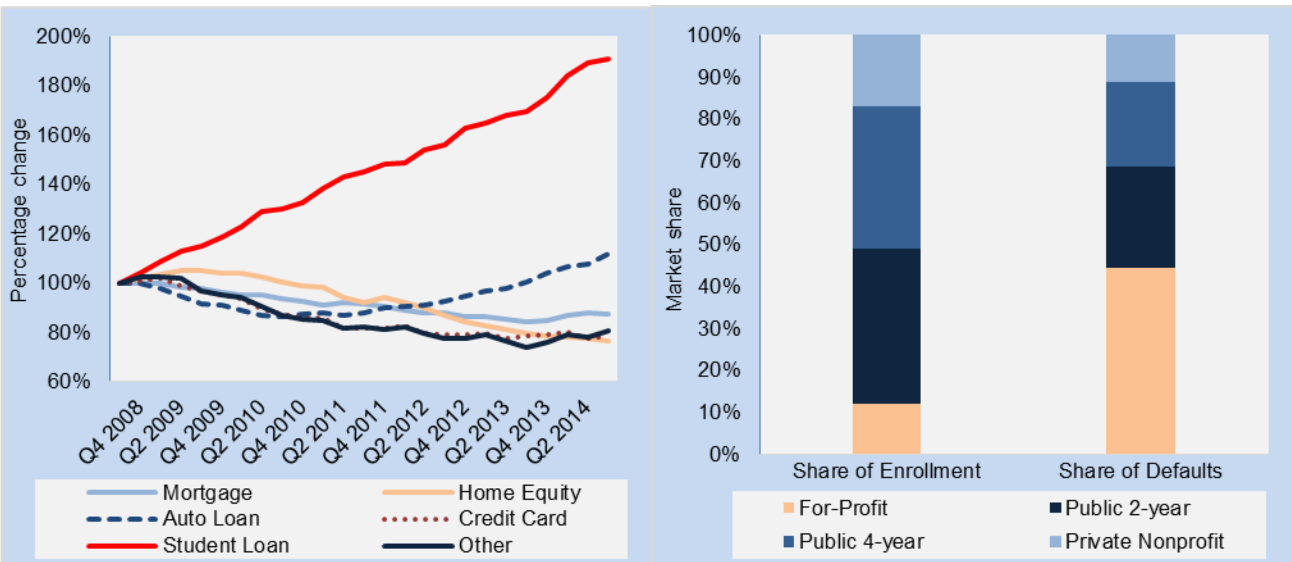

Figure 2a – 2b: 2a. Cumulative percent change in consumer debt in the US by types since Q3 2008; 2b. Education sectors' share of enrolment for 2012-2013 and FY 2011 three-year cohort default rates (CDRs) Source: *New York Federal Reserve Bank, US Department of Education*

Since the 2008 recession, private colleges have seen a decline in student enrollment rate and became entirely dependent on regular cash infusions from the government's financial aid programs, which accounts for almost 90% of their annual revenue. Nevertheless, the Obama administration is considering restricting these schools from accessing federal aid fund by setting an 'employment' benchmark that schools must meet in order to tap on federal aid. For example, if the programs' cohort default rate is higher than 30% for three consecutive years, the school will lose access to the federal assistance.

Figure 3 shows the aggregate RMI 1-year PD for all USEDU Index constituents. USEDU Index is a market cap weighted stock index of 13 for-profit education companies, whose shares are publicly traded in the US. The Aggregate RMI 1-year PD for these 13 companies indicated a gradual rising trend from around 5bps in mid Feb to the current 10bps. The increment of aggregate RMI 1-year PD is not much, but it demonstrates the increasing credit risk of the sector.

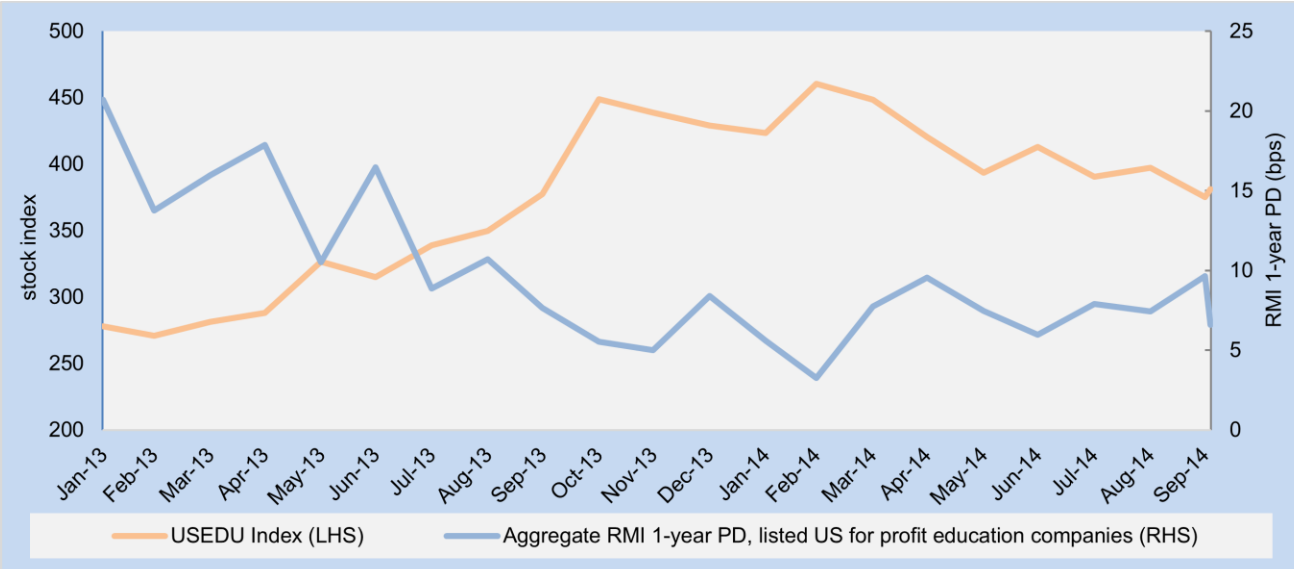

Figure 3: Aggregate RMI 1-year PD for USEDU Index and USEDU Index (constituents: APEI US, APOL US, BPI US, CPLA US, CECO US, COCO US, DV US, EDMC US, GHC US, LOPE US, ESI US, LINC US, and STRA US) Source: *Risk Management Institute, Bloomberg*

The Department of Education stated that the default rate of federal student-loan drops to 13.7%. That means for those who left school in fiscal 2011, 13.7% of students defaulted on their loans by this year. This number dropped from 14.7% in fiscal 2010 could be attributed to an improving economy and a surge in the enrollment in the federal debt-forgiveness programs. However, this change is actually caused by the revision of default definition. Historically, the government measured defaults within the first two years of students leaving school. If we stick to that definition, the student loan default rate should actually increase from 9.1% in fiscal 2010 to 10.0% in fiscal 2011.

The environment for public-listed private schools going forward is to face with stiffer regulations of funds and high unemployment rate of students in the labor market, which indirectly may lead to more student loan defaults. The government's stipulated private school requirements for better transparency and accountability will just set future students be more selective before enrolling any program and thus choose. Schools with better recognition and financial health stand out from the crowds. For the schools in financial distress, Washington may have to bail them out by relocating their students into other programs. If not, the government must write off the loans given to the students who can't be placed out other institutions. Any write offs of student loan will cost American taxpayers millions of dollars.

Credit News

Samsung earnings slump as Galaxy smartphones struggle

Oct 7. Samsung, the maker of Galaxy phones has been finding tough competition in its stronghold – the large-screen smart phones, from Apple with introduction of its bigger phones and from other Chinese competitors like Xiaomi and Lenovo who now pack in more features in their cheaper smart phones. Samsung managed a lower incremental market share of shipments due to lower demand reported in China and India. While total smartphone shipments rose in the June-Sep quarter, the mobile unit's profit margin shrank on higher marketing spending and lower average selling prices for devices and Samsung's operating profit fell 60% to USD 3.8bn. Samsung stock is now down close to 22% to KRW 1.17mn from its peak in early June 2014. (Bloomberg)

Fund managers pull out of Hong Kong companies amid rising risk

Oct 7. The mainstay sectors in Hong Kong of retail, tourism and property are likely to suffer due to pro-democracy protests and rising political risks and fund managers are pulling funds out of local Hong Kong companies in recognition of these headwinds. The political upheaval has also come at a time of soft earnings momentum for the Hong Kong companies for the last few quarters. Moreover, the HK index Hang Seng still remains more expensive in valuation terms with a 17% premium to Asian peers vs. mainland index MSCI China at a 29% discount and could hasten portfolio exits. (SCMP) (Subscription required)

Apple sapphire partner GT Advanced files for bankruptcy protection

Oct 6. Apple Inc.'s technology partner, GT Advanced Technologies Inc. that runs the world's largest artificial-sapphire factory has filed for bankruptcy protection as its prospects have been hurt after Apple moved away from using synthetic sapphire in favor of glass in its products. Apple in its new series of iPhones has avoided sapphire after it proved brittle and cracked when phones were dropped from various heights and angles. Apple Inc. has also withheld a USD 139mn payment due to GT Advanced. GT shares fell 93% on 6 Oct after announcing its intention to file for bankruptcy. (WSJ)

Hewlett-Packard confirms plans to split in two, cut an additional 5,000 jobs

Oct 6. Computer and printing major Hewlett-Packard has announced a spin-off of its business into two parts - one company focused on servers, software and cloud technology, and the other focusing on the legacy computers and printers business. HP plans to make about 5,000 jobs redundant from the move and cut costs that it hopes to claw back into research and development. The split into two lean organizations is expected to boost independence and flexibility to adapt quickly to market and customer dynamics. Both companies Hewlett-Packard Enterprise and HP Inc. will be separately listed. (Forbes)

Credit Suisse excess swaps collateral falls by 45%

Oct 2. While Credit Suisse remains the biggest US swaps clearer by required customer collateral, its excess collateral has fallen by 45% since the end of June. Since June 30, when figures from the NFA showed that the excess collateral had reached USD 3.3bn at Credit Suisse given that its required client collateral was USD 7.2bn, required collateral has grown further to more than USD 8bn on September 15, while the excess has almost halved. (Risk Net) (Subscription required)

Big banks face regulatory risks but set to post strong results (The Australian) (Subscription required)

Greek budget leaves creditors unconvinced on Exit (Bloomberg)

Regulatory Updates

CFTC close to fixing Dodd-Frank commodity option woes

Oct 6. The US Commodity Futures Trading Commission (CFTC) is looking to resolve an ambiguity in the Dodd-Frank Act regulation pertaining to the definition of swap contracts such as those on natural gas supply deals to buy additional volumes in the event of cold weather. Since the currently prescribed definition of swaps is a cause of confusion and misinterpretation for energy companies, CFTC is now designing a seven-part test to help companies determine whether physical contracts with embedded volumetric optionality should be classified as swaps or not. The clarification should help the energy firms in consistent recognition and proper regulatory treatment of swap contracts avoiding protracted negotiations and higher compliance costs. (Risk.net) (Subscription required)

FSOC may tweak process for spotting super-risky firms

Oct 6. The US Financial Stability Oversight Council (FSOC), a council comprising of the country's main financial regulators is looking to change the process for identifying the systemically important insurers and non-bank financial companies. The body has identified 3 such companies - American International Group Inc. (AIG), Prudential Financial Inc. and GE Capital as Systemically Important Financial Institutions (SIFI), and advocated stricter oversight over them to protect the financial system. The 2010 Dodd-Frank Wall Street Reform Act had defined banks with more than USD 50bn in assets as "systemic" but left it to FSOC to determine whether some non-banks also deserved the tag. (Reuters)

RBI amendments to Basel III open riskier avenue

Oct 2. According to Fitch, given that the AT1 market for Indian banks remains untested, the new features of additional Tier 1 (AT1) instruments may bring a riskier asset class to retail investors. The Reserve Bank of India's (RBI) amendments to Basel III capital norms, which may help banks to meet the sector's USD 200bn Basel III capital needs, include allowing AT1s to have a shorter maturity of up to five years, be temporarily written down at a pre-specified trigger point, and sold to retail investors. These may bring about moral-hazard risks, as the RBI may have to bail out retail investors, and because of these changes, the banks who may still not be able to fulfil the entire AT1 requirements will issue bank capital instruments in domestic market. (International Business Times)

Banks boost equity, loan provisions in H1 ahead of ECB tests

Oct 2. Euro zone's 20 largest listed banks increased equity by 4 percent, or EUR 26bn (USD 33bn) and set aside a similar amount for bad loan loss provisions. These actions were taken as a response to the potential outcome of European Central Bank stress tests and the rulings on whether banks must raise cash, or revalue assets. However, since the value of the loan collateral has fallen, bank’s capital will seriously be impacted in case the ultimate loss on these loans is higher than expected. Given this, the ECB wants the stress tests to make banks keep significant amounts of capital in the run up. (Reuters)

Banks avoiding covered bonds for LCR buffer over liquidity fears

Oct 1. Concerning the liquidity problems in stressed environments, European banks are limiting covered bonds usage for their liquidity coverage ratio (LCR) liquidity buffers. Defined by the Basel Committee on Banking Supervision's revised version of the liquidity coverage ratio (LCR) in January 2013, covered bonds are classified as a Level 2A asset and can comprise up to 40% of a bank's total stock of liquid assets after haircuts are applied. However, to meet liquidity requirements, banks are limiting the use of them, because they are not considered to be liquid under stress. (Risk Net) (Subscription required)

G20 regulators agree on plan to minimise currency manipulation

Oct 1. The Financial Stability Board (FSB), a regulatory task force for the G20 countries, has proposed to extend the daily fixing window of currencies from 1 minute to 5 minutes in order to make it more difficult to manipulate currency rates. The FSB has also proposed that the fix be drawn from a wider range of price feeds and transaction data during the fixing window. The planned reform is on the back of multiple instances of traders colluding to influence the currency fix rate that is determined at 4pm London Time with advance information of client flows. The daily fixing sets the benchmark rates for the USD 5tn a day global spot currency market. (SCMP) (Subscription required)

DBS chief wants of Basel fallout (Indian Express)

IMF urges more regulation of USD 70tn shadow banking system (Bloomberg)

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