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Corporates

Ruby Tuesday Will Close Underperforming Restaurants in Planned Turnaround, a Credit Positive

Last Thursday, Ruby Tuesday Inc. (B3 stable) announced that it will close 95 underperforming restaurants of its 646 company-operated restaurants as of 31 May 2016, as part of an initiative to turn around negative same-restaurant sales (SRS) and traffic trends and improve profitability, a credit positive. The company plans to improve its food and beverage offering, focus on its Garden Bar, and improve the overall restaurant experience.

The company expects that closing the 95 underperforming restaurants will improve EBITDA by $12-$14 million annually. The cost of closing the restaurants will be $72-$81 million, with $30-$37 million of cash charges related to store closures, lease terminations and other charges. The company expects to offset cash charges with $35-$45 million of proceeds from the sale of owned properties.

Casual restaurants such as Ruby Tuesday have faced intense competition from other casual restaurants as well as from the quick-service restaurant (QSR) segment. QSRs have introduced value meals (two items for $2, or four items for $4, etc.) and have been able to offer lengthy promotions because of low commodity costs, weakening casual restaurants’ SRS results and traffic trends. Ruby Tuesday reported a 3.7% decline in SRS for the fourth quarter and 1.4% for the fiscal year that ended 31 May 2016.

We expect Ruby Tuesday to benefit from the proposed changes through a modest level of improved traffic and SRS. We have seen other restaurant companies such as El Pollo Loco (unrated) and California Pizza Kitchen (B3 positive) make changes to their menu and refresh restaurant interiors that have improved SRS trends. Ruby Tuesday has had positive feedback on menu changes, which include removing some unpopular items and adding more value items, and new restaurant looks in small tests in several markets.

Pro forma debt/EBITDA reflecting the EBITDA improvement from the store closings only, is about 4.5x, versus 4.8x as of 31 May. Despite the improved leverage, which meets our quantitative guidance for a higher rating, Ruby Tuesday will need to show it can reverse its negative SRS and traffic trends before we would consider an upgrade for the company.

The biggest risk for Ruby Tuesday is if the planned changes do not generate additional traffic from new customers or if existing customers reduce visits because they do not like the menu changes, thereby continuing or worsening the negative traffic trends. With no material maturities before its $212.5 million 7.625% senior notes due in May 2020 (the company’s undrawn $50 million revolver expires in December 2017), we believe that Ruby Tuesday has time to institute the changes and generate increased traffic. We calculate that the company generates $30-$40 million of free cash flow that will allow it to begin to roll out the menu changes and some model refreshes in the next few quarters.

Ruby Tuesday’s B3 corporate family rating reflects its weak operating performance in part driven by negative SRS and traffic trends that have resulted in modest interest coverage and relatively high leverage. For the 12-month period that ended 31 May 2016, pro forma EBIT coverage of interest expense was modest at about 1.2x, while we consider leverage relative to peers high at around 4.8x. The company’s high level of brand awareness, material scale, strategic focus on advertising, cost saving initiatives and adequate liquidity support its ratings.
Cintas’ Planned Acquisition of G&K Is Credit Negative

On Tuesday, Cintas Corporation, which issues debt through its Cintas Corporation No. 2 (A2 review for downgrade) subsidiary, said that it had agreed to acquire G&K Services Inc. (unrated) for about $2.2 billion. The planned transaction, which Cintas expects to close by early 2017, is credit negative because it will more than double financial leverage. After the announcement, we placed Cintas’ ratings on review for downgrade.

Cintas plans to finance the acquisition with new and assumed debt. Upon completion of the deal, pro forma Moody’s-adjusted debt/EBITDA will exceed 3.5x and will likely remain well above 2.0x for the next two to three years, up from 1.4x for the fiscal year that ended 31 May. Profit margins will also decline until Cintas can realize expected synergies. Although the transaction will substantially weaken credit metrics, the company has a track record of maintaining sizable and consistent free cash flow generation and has committed to reducing debt quickly after the deal closes.

The acquisition will combine two of the largest uniform services companies in North America, solidifying Cintas’ lead in the market. Cintas estimates it can achieve $130-$140 million per year in synergies from cost reductions and the cross-selling of products. Because Cintas and G&K operate in many of the same markets, the realization of scale and route density improvements will be key to realizing these cost savings.

Achieving the targeted synergies will involve reorganizing operations at hundreds of sites, so the company believes it may take up to four years to reap the full benefits of the merger. In addition, forthcoming regulatory requirements for deal approval could force Cintas to divest certain attractive and profitable operations, potentially reducing the amount of synergy benefits.

Cintas’ liquidity profile is good, with about $130 million in cash and more than $100 million of availability in excess of current commercial paper outstanding under the company’s revolving credit facility due 2019, as of 31 May. Cintas is the largest provider of uniform programs in North America, as well as a provider of entrance mats, restroom products and services, first aid, safety and fire-protection products and branded promotional products to business customers. We expect revenues for fiscal 2017 (ending 31 May) of more than $5 billion before the G&K acquisition.
Xylem’s Planned Acquisition of Sensus Is Credit Negative

On Monday, Xylem Inc. (Baa2 review for downgrade) said that it had agreed to acquire Sensus USA Inc. (B2 stable) for about $1.7 billion. The planned acquisition, which Xylem expects to close by the end of the year, is credit negative because it will increase leverage. After the announcement, we placed Xylem’s ratings on review for downgrade.

Upon closing, Xylem’s pro forma debt/EBITDA would rise to 3.7x from about 2.7x for the 12 months that ended 31 March, while pro forma free cash flow/debt would slip below 10% from 10.7% for the last 12 months. Any downgrade of the company’s ratings would likely be limited to one notch, to Baa3 and Prime-3, based on our expectation that Xylem will use most of its near-term free cash flow to repay the short-term debt that we expect the company will raise to help fund the transaction.

Acquiring Sensus will provide Xylem with a presence in the advanced metering infrastructure (AMI) segment of the water industry, while also expanding its US footprint. AMI involves two-way wireless communication between a utility selling a commodity and the meter measuring consumption. We expect the combined company to maintain a leading position in the deployment of water AMI in North America, where the technology is gaining a greater share of the market for residential and small commercial water meters.

Xylem’s performance during the first half of 2016 has been steady. The water industry has historically expanded at levels commensurate with normalized global GDP growth rates and has demonstrated relative resilience to recent economic softness. Global population growth, water scarcity, improving energy efficiency, increasingly stringent environmental and government regulations and rising industrialization in emerging markets should boost the industry’s annual growth rate above GDP levels for the foreseeable future. In addition, the longstanding need to repair and upgrade aging water infrastructure in the US and Europe is a potential upside.

Sensus’ metrics, excluding non-recurring items, have steadily improved during the past three years because of stronger end-market demand and cost-cutting initiatives. Restructuring actions, improved sourcing with suppliers and redesigning products to lower costs have been instrumental in creating a leaner cost structure at the company.

Xylem provides water and wastewater infrastructure equipment and services across the entire water cycle: collection, distribution use and return to environment. The Water Infrastructure segment focuses on the transportation, treatment and testing of water, while the Applied Water segment focuses on the uses of water as it relates to residential, commercial, industrial and agricultural markets. The company reported revenues of approximately $3.7 billion for the 12 months that ended 31 March 2016.
Deutsche Wohnen's Acquisition of Nursing Facilities Is Credit Negative

Last Friday, Deutsche Wohnen A.G. (A3 stable), Germany’s second-largest residential property company, announced that it had agreed to buy 28 nursing and assisted-living facilities in Germany. The acquisition is credit negative because it will increase the company’s leverage, based on our preliminary estimates.

The acquisition includes 28 facilities generating €27 million of rental income annually. Deutsche Wohnen stated that it expects a net initial yield in mid- to high-single-digits from the transaction, which implies an acquisition price of €300-€500 million.

Although Deutsche Wohnen has not disclosed the deal’s financial terms or how it intends to fund it, we estimate that it will likely fund it mostly with debt, given that its leverage has continued to decrease in the first half of the year. As of 20 June 2016, Deutsche Wohnen’s debt/total assets was 37%, down from 40.1% in June 2015, according to our preliminary calculations. Assuming a 100% debt-funded transaction, we calculate that Deutsche Wohnen’s debt/total assets will deteriorate to around 39%. The company had €296 million on its balance sheet at the end of June 2016 and could use some of it to partly fund the acquisition and soften the effect on leverage. However, the increase in leverage will not affect Deutsche Wohnen’s A3 rating because its debt/total assets will remain below the 45% threshold that we expect the company to sustain for the current A3 rating.

More positively, the acquisition will improve Deutsche Wohnen’s property portfolio diversification both in terms of the company’s business and geography. We estimate that the nursing and assisted-living business will constitute 12% of Deutsche Wohnen’s rental income, up from 9% in the first half of 2016. The acquired facilities are spread across Germany, with Bavaria accounting for 24% of the facilities’ rental income, and North-Rhine Westphalia constituting 22%. This will reduce Deutsche Wohnen’s current concentration in the Berlin metropolitan area to around 63% of total assets by value from approximately 65% currently.

Assisted-living housing is a long-term senior care option that provides personal care support services. An aging population and an increasing life expectancy suggest strong future long-term growth for the assisted-living business (see exhibit). According to the Nursing Home Rating Report 2015, the assisted-living market in Germany will grow by around 15% over the next decade.
The facilities that Deutsche Wohnen acquired have an average occupancy of 87% and are leased by two of Germany’s largest nursing home operators: Pro Seniore (unrated), which generates 79% of the facilities’ rental income, and Korian (unrated), which generates 14%. Some 79% of the lease agreements are on a triple net lease basis, hence the acquisition will not significantly raise Deutsche Wohnen’s investment needs.

Deutsche Wohnen owns and manages a multi-family residential rental portfolio of around 160,000 units, located predominantly in the Berlin metropolitan area, with a fair value of €13.8 billion as of June 2016. Deutsche Wohnen also sells residential units and operates nursing facilities.
Korean Builders’ Declining Overseas Orders Are Credit Negative

On Monday, the International Contractors Association of Korea said that Korean construction firms’ aggregate new order wins from overseas markets during the first eight months of 2016 dropped 45% from a year earlier to $17 billion, the lowest level since 2009 during the global financial crisis. The credit-negative decline in new overseas orders (see exhibit) will reduce Korean construction companies’ revenue, earnings and cash flow since overseas markets account for a significant portion of revenue and earnings. Overseas revenue for Korea’s largest construction company, Hyundai Engineering & Construction Co Ltd (unrated), accounted for 61% of its total revenue in 2015. In contrast, POSCO Engineering & Construction Co. Ltd.’s (Baa3 review for downgrade) overseas business contributed 26% of its standalone revenue in 2015.

The immediate effect on the builders’ revenue and earnings is limited because most leading companies have sizable order backlogs that can cover two to three years of overseas revenue. However, we expect this unfavorable situation to persist and the effect to become more material over the next one to two years as the order backlog begins to shrink. In addition, the contraction in new orders likely will heighten price competition among contractors, which would undermine their profitability.

In response to the decline of overseas orders and given the rebound in domestic housing prices, Korean construction companies have expanded their domestic homebuilding business. The 10 largest builders plan to launch housing projects comprising about 170,000 units in the second half of this year, up 57% from 108,000 in the first half of the year. However, the increased housing supply could significantly increase unsold inventory over the next 12-18 months.

The decline in order wins is due partly to sluggish new order placements in the Middle East, which is the key overseas market for Korean builders. The low oil price environment has reduced these countries’ financial resources available to fund large scale infrastructure/plant projects. Korean contractors’ new order wins in the Middle East decreased by 33% to $4.7 billion in first-half 2016 from $7.1 billion a year earlier, and by 81% from $24.7 billion in first-half 2014. New order wins in Asia also declined by 47% to $6.9 billion from a year earlier.
Measures to Cool Rising Property Prices in Nanjing and Suzhou, China, Are Credit Negative for Developers

On 11 August, authorities in the Chinese cities of Nanjing and Suzhou announced measures aimed at curbing appreciation in residential property prices and land prices following a price run-up since the fourth quarter of 2015. The new measures, which apply both to homebuyers and property developers, are credit negative for property developers with material operations in these cities because they will likely suppress sales by reducing the number of eligible buyers and hindering second-home buyers from upgrading to larger residences. The measures will also increase developers’ funding needs.

Among our rated developers, Golden Wheel Tiandi Holdings Company Limited (B2 stable), Future Land Development Holdings Limited (Ba3 stable), Yanlord Land Group Limited (Ba3 stable), Road King Infrastructure Limited (B1 stable), CIFI Holdings (Group) Co., Ltd. (Ba3 stable) and Shimao Property Holdings Limited (Ba2 stable) have material operations in these two cities. However, we expect the effect on their credit quality to be manageable given their various financial and/or business cushions.

The key measures in both cities include raising the down payments for the mortgages of second homes (i.e., consumers selling their existing home and buying another or purchasing a second home). The measures also tighten the requirements for property developers when bidding for land and pre-selling properties.

Nanjing (excluding the Gaochun and Lishui Districts) raised its down-payment requirement to 35%-50% of a property’s value from 30%-40%, while Suzhou (excluding the Wujiang District) increased it to 50% from 40%. The moves reverse the reduction on down-payment requirements that the People’s Bank of China initiated nationally in September 2014. Suzhou also tightened the requirement for non-residents’ purchases of second homes in the city, after having loosened home-purchase restrictions in the third quarter of 2014.

Additionally, Suzhou raised the down payments that developers must make when purchasing land at auction, and both cities tightened requirements for developers pre-selling properties. These changes will increase developers’ upfront capital requirements and lengthen their cash conversion cycles, both of which will increase developers’ funding needs.

Our six rated developers generated more than 20% of their contracted sales or revenues from Nanjing and Suzhou and/or had more than 20% of their land bank in either or both cities (see Exhibit 1). We expect both cities to remain the main contributors to these companies’ sales over the next six to 12 months. Golden Wheel has the highest exposure because Nanjing is its home market.

## EXHIBIT 1
### Rated Chinese Developers with Material Exposures in Nanjing and Suzhou in 2015

<table>
<thead>
<tr>
<th>Issuer</th>
<th>Percent of Land Bank by Gross Floor Area as of December 2015</th>
<th>Percent of Contracted Sales Value for 2015*</th>
<th>Percent Contracted Sales from Nanjing and Suzhou by Sales Value*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Golden Wheel Tiandi</td>
<td>30% 0%</td>
<td>65% 0%</td>
<td>65%</td>
</tr>
<tr>
<td>Future Land</td>
<td>8% 15%</td>
<td>18% 21%</td>
<td>39%</td>
</tr>
<tr>
<td>Yanlord Land</td>
<td>16% 7%</td>
<td>12% 15%</td>
<td>27%</td>
</tr>
<tr>
<td>Road King Infrastructure</td>
<td>0% 9%</td>
<td>0% 27%</td>
<td>27%</td>
</tr>
<tr>
<td>CIFI</td>
<td>3% 14%</td>
<td>5% 18%</td>
<td>23%</td>
</tr>
<tr>
<td>Shimao</td>
<td>5% 1%</td>
<td>15% 6%</td>
<td>21%</td>
</tr>
</tbody>
</table>

Note: * Golden Wheel, Yanlord and Shimao did not disclose contracted sales in these cities. Their data are based on their revenue breakdowns in 2015.

Sources: The companies
Despite the cities’ new measures, we believe Yanlord and Shimao have quality products, strong brand names and sound financial and liquidity positions that provide them with some buffer to manage the risks resulting from the tighter measures. For Golden Wheel, stable rental income from its investment property portfolio and a cautious expansion strategy temper the measures’ effects. Although CIFI’s, Future Land’s and Road King’s sales growth could be affected by the tightening regulations, their existing financial positions provide some buffer to accommodate a potential slowdown in sales.

Nanjing and Suzhou are major second-tier cities in China’s Yangtze River Delta area. Their strong economic fundamentals and the country’s eased monetary policy have raised demand for properties in these cities, which has driven up property prices over the past six to nine months. In July, residential property prices in Nanjing rose 46.1% year on year, and 60.7% in Suzhou (see Exhibit 2), according to the China Real Estate Information System. We expect further policy tightening in cities where price growth has been strong, and that the initiatives will likely lower property demand and price growth.

EXHIBIT 2
Year-on-Year Residential Housing Price Changes in Nanjing and Suzhou

Source: China Real Estate Information System
Korean Government’s Temporary Tariff Cut Is Credit Negative for KEPCO

Last Thursday, amid scorching summer temperatures, Korea’s Ministry of Trade, Infrastructure and Energy (MOTIE) raised the electricity range that households can consume at given progressive rates by 50 kilowatts per hour (kWh) from July to September this year. The adjustment effectively reduces tariffs for Korea Electric Power Corporation (KEPCO, Aa2 stable), which will constrain the company’s operating profit growth and weaken its profit predictability, a credit negative.

The higher limits under Korea’s progressive tariff system for residential use (see Exhibit 1) are aimed at limiting the increase on household electricity bills from rising electricity use during the hot summer months. The government estimates that the temporary adjustment will reduce residential users’ aggregate electricity bills by KRW420 billion. We estimate that KEPCO’s operating profit will decline by a similar amount.

<table>
<thead>
<tr>
<th></th>
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<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>60.7</td>
<td>Less than 100 kWh</td>
<td>Less than 150 kWh</td>
</tr>
<tr>
<td>2</td>
<td>125.9</td>
<td>101-200 kWh</td>
<td>151-250 kWh</td>
</tr>
<tr>
<td>3</td>
<td>187.9</td>
<td>201-300 kWh</td>
<td>251-350 kWh</td>
</tr>
<tr>
<td>4</td>
<td>280.6</td>
<td>301-400 kWh</td>
<td>351-450 kWh</td>
</tr>
<tr>
<td>5</td>
<td>417.7</td>
<td>401-500 kWh</td>
<td>451-550 kWh</td>
</tr>
<tr>
<td>6</td>
<td>709.5</td>
<td>More than 500 kWh</td>
<td>More than 550 kWh</td>
</tr>
</tbody>
</table>

Source: Korea’s Ministry of Trade, Industry and Energy

We expect MOTIE’s adjustment to weaken KEPCO’s funds from operations/debt on a consolidated basis by around one percentage point to 27%-29% over the next 12-18 months, compared with our previous projection. Any unexpectedly strong rebound in fuel costs, material tariff cut, and/or material reduction in coal-fired power plants’ capacity utilization (90% in 2015) during the period would affect actual results.

The government’s surprise move highlights the tariff system’s weak transparency. The absence of an automatic, transparent fuel-cost pass-through tariff mechanism is a fundamental credit weakness for KEPCO. Tariff adjustments are subject to MOTIE’s approval. Consequently, the predictability and stability of KEPCO’s cash flows from operations and profitability will remain low, given the inherent volatility in the cost of imported fuels and the government’s continued intervention on tariffs (see Exhibit 2).
KEPCO’s Net Profits, 2008-15

The company’s profits have been volatile.

KEPCO recorded net losses in 2008-12, when fuel costs rose but the government did not allow sufficient tariff increases to cover the higher fuel costs because of its concerns that inflation would follow a large rise in tariffs, increasing consumers’ financial burden. Since 2014, KEPCO has benefited from steady tariffs and a decline in fuel costs.

However, we do not expect the weak transparency in KEPCO’s tariffs to materially affect the utility’s credit quality over the next 12-18 months. We assume a modest recovery in fuel costs from the current low level and also expect increased power generation from KEPCO’s cost-competitive baseload nuclear reactors and coal-fired power plants as new baseload power plants with an aggregate capacity of around 11.3 gigawatts are scheduled to begin operations in 2016-17.
Bulgarian Banks’ Asset Quality Review and Stress Test Results Are Credit Positive

Last Saturday, the Bulgarian National Bank (BNB) published the results of its first bank asset quality review (AQR) and stress test. The BNB’s tests show the system’s strong capital position, with an AQR-adjusted common equity Tier 1 (CET1) capital ratio of 18.9% as of December 2015, well above the 4.5% regulatory minimum, a credit positive.

The stress test uses two macroeconomic scenarios over a three-year horizon until 2018. The tests show that under the baseline scenario, the banking system’s CET1 capital ratio improves to 22.2% by the end of 2018, while under the adverse scenario, CET1 falls to a still-high 14.4%, confirming banks’ resilience to potential shocks.

The AQR, conducted between February and June 2016, covered all 22 banks operating in the country and excluded six foreign bank branches. Total assets of BGN84.2 billion at 31 December 2015, or 96% of the banking system, were subjected to the AQR, and the BNB said that it reviewed more than 3,400 individual credit files, equivalent to BGN21.6 billion or 75% of the banks’ corporate and large small and midsize enterprise loan books.

The stress test was conducted in July 2016 upon the conclusion of the AQR in order to assess the banks’ resilience to shocks from hypothetical negative macroeconomic developments. According to the BNB, the stress test was conducted according to predefined guidelines consistent with the 2016 European Banking Authority (EBA) European Union-wide stress test methodology, and the European Commission and the EBA were regularly informed and asked for their opinion at all stages of the process.

The AQR adjustments affect the system’s CET1 by BGN665 million, or 1.3% of risk-weighted assets, mainly owing to additional provisions that the banks must reflect in their financial statements as of 31 December 2016. Although all banks’ AQR-adjusted CET1 was above the required regulatory minimum, the BNB has developed follow-up plans in line with individual results. The plans include measures aimed at maintaining existing capital buffers for some banks or increasing capital buffers and decreasing risk-weighted assets for others.

The stress test’s two macroeconomic scenarios over a three-year horizon until 2018 are shown in Exhibit 1: a baseline scenario corresponding to the BNB forecast of March 2016, and an adverse scenario that corresponds to low-probability hypothetical developments.

EXHIBIT 1
Bulgaria National Bank’s Macroeconomic Assumptions for Banks’ Stress Test

<table>
<thead>
<tr>
<th></th>
<th>Baseline Scenario</th>
<th>Adverse Scenario</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2016</td>
<td>2017</td>
</tr>
<tr>
<td>Inflation</td>
<td>-0.8%</td>
<td>1.1%</td>
</tr>
<tr>
<td>Real GDP Growth</td>
<td>2.2%</td>
<td>2.5%</td>
</tr>
<tr>
<td>Residential Property Price Growth</td>
<td>1.2%</td>
<td>1.2%</td>
</tr>
<tr>
<td>Unemployment Rate</td>
<td>8.0%</td>
<td>7.5%</td>
</tr>
</tbody>
</table>

Source: Bulgarian National Bank

1 This excludes a 2.5% capital conservation buffer and 3% systemic risk buffer that took effect in 2014.
Exhibit 2 shows that under the baseline scenario, which reflects the BNB’s assessment of the most probable macroeconomic and financial developments, the banking system’s CET1 capital ratio improves to 22.2% by the end of the forecast horizon. Under the adverse scenario, the banking system’s CET1 capital ratio falls, but remains a high 14.4% by the end of 2018. Under both scenarios, banks’ capital positions remain strong and indicate adequate resilience to absorb the tested shocks, although results vary across individual banks.

Similar to the approach in the EBA’s latest EU-wide stress test, the stress test on the Bulgarian banking system does not contain a pass/fail threshold. The results feed through the Supervisory Review and Evaluation Process, through which the BNB sets bank-specific, or Pillar 2, minimum capital requirements.

As shown in Exhibit 3, the two weakest-performing banks under the stress test are First Investment Bank AD (unrated) and Investbank AD (unrated), the only banks whose CET1 becomes negative under the adverse scenario. For both banks, the BNB has defined a clear action plan and measures to be taken to strengthen their capital buffers. The results for Raiffeisenbank (Bulgaria) EAD (Ba3 stable, b12) and Municipal Bank AD (B1 stable, b2) confirm their strong capital buffers and ability to absorb shocks, a key support for their ratings. Raiffeisenbank’s CET1 of 25.6% as of year-end 2015 falls slightly under the adverse scenario, but remains at a still-high 22.4%. Municipal Bank’s CET1 of 16% as of year-end 2015 falls to 6.5% under the adverse scenario.

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2 The bank ratings shown in this report are the bank’s local currency rating and baseline credit assessment.
EXHIBIT 3

Individual Bulgarian Banks’ CET1 Ratios under BNB’s Adverse Scenario at December 2018

Source: Bulgarian National Bank
Sovereigns

Guatemala’s Tax Reform Proposal Is Credit Positive

Last Friday, Guatemala’s (Ba1 stable) government presented to congress a tax reform proposal that seeks to increase tax revenues by 2.5% of GDP. The proposal is credit positive because it addresses one of Guatemala’s key credit challenges, low government revenues.

If approved as proposed, the government estimates that new taxes would generate 1.1% of GDP, while measures to strengthen tax administration would yield an additional 1.4% of GDP, raising 2.5% of GDP. The proposal includes raising the income tax in a progressive form and increasing the tax of oil derivatives, measures that would yield the most revenue, and others such as increasing the tax on cement and raising royalties charged for mineral extraction. The oil tax would include a counter-cyclical rule that would move with oil prices: if oil prices rise above a certain threshold, the tax per gallon would decrease.

The measures to strengthen tax administration seek to expand the taxpayer base by providing fiscal incentives to discourage the underreporting of value-added tax (VAT) in business transactions, and encouraging electronic billing, which would help track payments in the system and better identify evasion. The government also intends to transfer the responsibility for collecting certain municipal taxes to the federal tax administration unit (Superintendencia de Administración Tributaria) to improve tax collection.

Guatemala has the third-lowest ratio of government revenues to GDP among our rated 131 countries, only above Nigeria and Sharjah in the United Arab Emirates. In 2015, government revenues fell to 10.8% of GDP, below the already-low historical average of 11.6% of GDP, reflecting corruption in tax administration and lower taxes collected from oil derivative imports and VAT collections from gasoline, given the drop in oil prices. Low government revenues have not jeopardized the stability of public finances because government expenditures at just 12.3% of GDP in 2015 are also low relative to the Ba-rated median of 30.4%. However, low government revenues and a small government limit the resources available for social development needs. Guatemala’s extreme poverty increased to 23% of the total population in 2014 from 13.3% in 2011, while total public investment as a percentage of total government expenditure decreased to 18% in 2015 from 31% in 2008. These negative trends could cause a lasting reduction in potential growth if unaddressed.

Approval of the tax reform in congress may prove challenging because of the acute opposition of the Guatemalan population to pay more taxes, the highly fragmented nature of congress and the lack of a simple majority by the ruling party, the Frente de Convergencia Nacional, which has 23% of the seats in congress, and thus needs to broker an agreement with two or more other political parties. The private sector could also obstruct the implementation of new taxes. In the past, the private sector, through business chambers, has challenged the legality of new taxes in court, which have deemed them unconstitutional before they are even implemented.

Despite the challenges, the positive momentum of the government of President Jimmy Morales could aid passage of the tax reform because the government enjoys high approval ratings among the Guatemalan population given that it has continued to support the successful fight against corruption.
Botswana's Energy Regulatory Bill Supports Increased Electricity Supply, a Credit Positive

On 10 August, the Government of Botswana (A2 stable) announced the passage of the Energy Regulatory Bill, which we expect will have significant positive credit implications for the sovereign. Although the bill will not instantly boost Botswana’s electricity generating capacity, we expect that it will do so over time.

The World Bank estimated that Botswana’s lack of electricity generation capacity held back per capita real GDP growth on average by about 0.4 percentage points a year between 2003 and 2007, when the gap was below 100 megawatts, while we estimate it at about 200-300 megawatts today. Closing the gap would raise growth per capita by up to one percentage point a year. Moreover, it will improve the electrification rate, which was still only 53% of the population in 2012 (the latest year available), versus 28% in 2003, according to World Bank Development Indicators.

The bill will lead to the establishment of an independent Botswana Energy Regulatory Authority that will oversee development of the country’s legal framework for an electricity sector that until now had been guided by the Department of Energy at the Ministry of Minerals, Energy, and Water Resources. The new legal framework will facilitate private sector entry, particularly independent power producers (IPPs) in the electricity sector, which is currently dominated by the vertically integrated, state-owned Botswana Power Corporation.

The entry of IPPs into electricity generation will start unbundling the electricity value chain, where the Botswana Power Corporation currently monopolises generation, transmission and distribution. The independent regulatory authority will also help attract financing for IPP projects that funders until now have avoided because of various inefficiencies, including government-determined electricity tariffs that have not allowed for cost-recovery. In the future, the IPPs will be able to charge tariffs, approved by the independent regulator, that are both cost effective and consumer-friendly.

Two recently approved 300-megawatt extensions of the state-owned Morupule B electricity plant rely on IPPs. One of the 300-megawatt plants, to be completed in 2020, will be jointly operated by Korea’s POSCO Energy and Japan’s Marubeni. The additional electricity generation will reduce severe electricity shortages and frequent outages that Botswana has experienced over the past several years.

Increased electricity supply that would come on stream in 2019 or 2020, according to the government’s plans, will reduce Botswana’s reliance on costly (and unsustainable) imports. To close its electricity gap, Botswana has regularly relied on importing more than 40%, and sometimes up to 90%, of its electricity needs (see exhibit). In the fiscal year that ended 31 March 2015, most of the imports (almost 40% of distribution) were from Eskom Holdings SOC Limited’s (Ba1 negative) coal-fired power stations in South Africa, in addition to minor imports from NamPower, ZESCO and the Southern African Power Pool. However, this import dependence has made Botswana vulnerable to Eskom’s inefficiencies and South Africa’s power shortages, making electricity imports from South Africa increasingly costly and unreliable. The rising import bill has negatively affected Botswana’s current account and the budget through subsidies.  

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3 IPPs are private or non-government producers that own facilities that generate electric power for sale to utilities and other end-users. Besides IPPs, other forms of private sector involvement in the electricity sector include management and lease contracts, concession agreements, and divestiture.

The Energy Regulatory Bill will also help Botswana embark on a renewable energy path. Botswana’s current peak electricity demand is around 600 megawatts, and coal-fired plants (through both domestic generation and imports) supply 90%. Despite the country’s abundant endowment of solar energy, this source has so far accounted for less than 1% of the total mix. The recent global decline in costs of renewable energy technologies makes this source more affordable; drawing on it gives Botswana an opportunity to boost electricity generation and improve its sustainability while making supply more reliable through diversification.
US Public Finance

Paterson, New Jersey, Passes Levy to Prevent Immediate Cash Shortage, a Credit Positive

On Tuesday, the Paterson, New Jersey (Ba1 negative) city council passed an increased preliminary property tax levy for $149.2 million, eliminating the threat of major immediate cash shortfalls and the need to issue short-term debt to pay bills. The city council action is credit positive. Without an increased levy in place, the city’s already-weak financial position would be even more dire (see Exhibit 1).

Because the city’s underlying credit quality is weak, market access would have been a major challenge. Although details were not made public, city officials indicated that they had several possible options to address market access challenges and that they were confident that the city would have obtained short-term financing.

Even now that the levy has been approved, Paterson remains in a state of profound fiscal distress; the city’s reserves are narrow, liquidity is weak, and its equalized value, which is the estimated value of all taxable real and personal property, continues to decline (see Exhibit 2).
Despite the city council’s approval of the levy, Paterson will not see the bulk of the cash for nearly a month. The process is also complicated by the need to have the levy meet certain statutory standards (the levy must be at least 95% of the previous year’s levy) or get approval from the state, which reserves the right to reject a levy if it does not meet the requirements of state budget law. This is not an idle threat; on 8 August, the state Division of Local Government Services informed the city that it would not sign off on a previously passed $145 million property tax levy because it was insufficient to prevent immediate cash shortfalls. The agency’s action essentially vetoed the budget and barred Paterson from sending out quarterly tax bills, threatening a major cash shortfall, and forcing the city to pass the new levy on Tuesday. The city has stated that the new levy exceeds the statutory minimum and will not be subject to state review.

The city’s failure to pass a levy satisfactory to the state on the first try without bringing matters to a crisis is a continuation of ongoing political gridlock. Last March, the city’s woes came to a head and the city government was shut down for a day, except for certain essential services. The mayor and city council have frequently disagreed on ways to address the city’s financial woes, leading to a series of temporary budgets.

The gridlock between the mayor and city council centers on disagreement over increasing taxes versus cutting expenditures. Some government officials have argued that the city’s ability to absorb a tax increase is limited given its poor population, while others have asserted that a failure to generate more revenue will lead to service cuts to programs the population needs. During 2009-15, current fund revenues increased 18.9%, while expenditures increased 21.9%.

In a plus for bondholders, all of the city’s bonded debt is secured by the Municipal Qualified Bond Act, a program under which the state withholds state aid and uses it to pay debt service on behalf of the city. Additionally, Paterson’s bond anticipation notes are all issued via the Passaic County Improvement Authority and are guaranteed by Passaic County (Aa3 stable). The remainder of the city’s debt is in the form of state loans.
US State Highway Revenue Bonds Benefit from Record Gasoline Consumption

On 9 August, the US Energy Information Administration forecast that US gasoline consumption will set a record in 2016 (see Exhibit 1), increasing 1.7% over 2015 levels and surpassing the previous record set in 2007. Propelled by employment growth and lower gas prices, increased gasoline consumption is positive for state highway revenue bonds, which are typically secured by a pledge of state taxes on gasoline (among other things). Stronger gasoline tax receipts will strengthen debt service coverage on state highway revenue bonds and expand states’ borrowing capacity to finance highway maintenance projects with debt.

EXHIBIT 1
US Gasoline Consumption and Price
Low gas prices propel consumption higher.

Source: US Energy Information Administration

States’ motor fuels tax receipts slid during the recession and increased tepidly during 2010-12 (see Exhibit 2). Largely because of lower gas prices, gas tax receipts are now on a much stronger trend, and were up 0.9% in 2015 after growing 0.6% in 2014 despite improvements in fuel economy. The US Energy Information Administration (EIA) forecasts a decline in gasoline prices for the remainder of the year. Overall, EIA forecasts gas prices in 2016 to be more than 40% lower than the peak year in 2012.

EXHIBIT 2
US Motor Fuels Tax Receipts for Trailing Four Quarters
States’ motor fuels taxes are on the rise.

Source: US Census Bureau
We rate approximately $33 billion of state highway revenue bonds, which are usually secured by gasoline taxes, registration fees, motor vehicle sales taxes and sometimes other revenues such as dedicated sales taxes. Major issuers of highway revenue bonds include the Texas Transportation Commission (Aaa stable), the Maryland Department of Transportation (highway revenue rating Aa1 stable) and the Michigan Department of Transportation (highway revenue rating Aa2 stable).

Higher gasoline tax receipts are positive for these entities’ bonds. All else equal, higher pledged revenues mean stronger coverage of debt service by pledged receipts. The median coverage of maximum annual debt service on highway revenue bonds in 2015 was 4.3x, up from 3.7x in 2012. The improvement in coverage reflects both more gasoline consumption and the willingness of some states to increase the tax rate on gasoline. According to the National Conference of State Legislatures, 17 states have increased their gas taxes since 2013.

Additionally, better debt service coverage will allow states that want to catch up on deferred highway maintenance to finance more projects through debt. Most highway bonds are issued with a debt limit (additional bonds test) requiring pledged receipts to cover debt service by a certain magnitude before a state can issue more highway revenue bonds. The difference between actual coverage and the additional bonds test is called headroom, and it indicates how much borrowing capacity states have under their highway programs. The median headroom (maximum annual debt service coverage minus additional bonds test) in 2015 was around 1.5x, up from 1.3x in 2012, and it is poised to continue improving if consumption increases as forecast.

The improvement in headroom would bestow greater borrowing capacity on states at a time when reinvestment in highway assets has stalled. States have deferred highway maintenance for a decade (see Exhibit 3), leading to a higher average age of highway assets and pent-up capital investment needs. Considering the trend of growing pledged revenues, willingness by some states to increase gasoline taxes, and aging of capital assets, states may soon be poised to resume investing in their highways.

EXHIBIT 3
State Investment in Highways
States have deferred investments in highway assets.

Source: US Bureau of Economic Analysis
NEWS & ANALYSIS

Corporates
» Perrigo’s Lower Guidance Signals a Deleveraging Delay and Raises Event Risk
» Macy’s Closure of 100 Stores Is Credit Positive
» SM Energy’s Permian Acquisition Broadens Portfolio, a Credit Positive
» Hoover’s Credit-Positive Merger Will Double Its Size and Lower Leverage
» Russian Property Developer LSR Group Will Benefit from Revival in Mortgage Volume

Infrastructure
» CELES C D Will Recognize a BRL256 Million Extraordinary Loss in 2016
» Western Power Distribution’s Lower Dividends and Target Gearing Are Credit Positive
» Dalrymple Bay Coal Terminal Will Likely See More Volatile Cash Flow with Peabody Energy’s Restructuring

Banks
» Germany’s Bail-in Guidance on Bank Debt Removes Uncertainty, but Contrasts with the Rest of Europe
» SpareBank 1 SR’s Increased Problem Loans and Impairments Signify Credit-Negative Risks in Oil-Related Exposures
» European Bank Regulators Recommend EU Reciprocity of Estonia’s Risk Buffer, a Credit Positive
» Bank Hapoalim Acquires Credit Insurance Against Guarantees, a Credit Positive

Insurers
» Aegon’s Weak US Results Offset Its Credit-Positive Acquisition of Cofunds

Sovereigns
» Flaring Russia-Ukraine Tensions Threaten Russia’s Incipient Recovery, a Credit Negative
» South Africa Sanctions Five Banks to Curb Money Laundering, a Credit Positive for Sovereign
» Tanzania Will Benefit from Railway Linking It with Land-Locked Eastern African Countries
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