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Instability in the Mexican financial sector: is panic justified or is it time to buy?

WHAT HAPPENED?

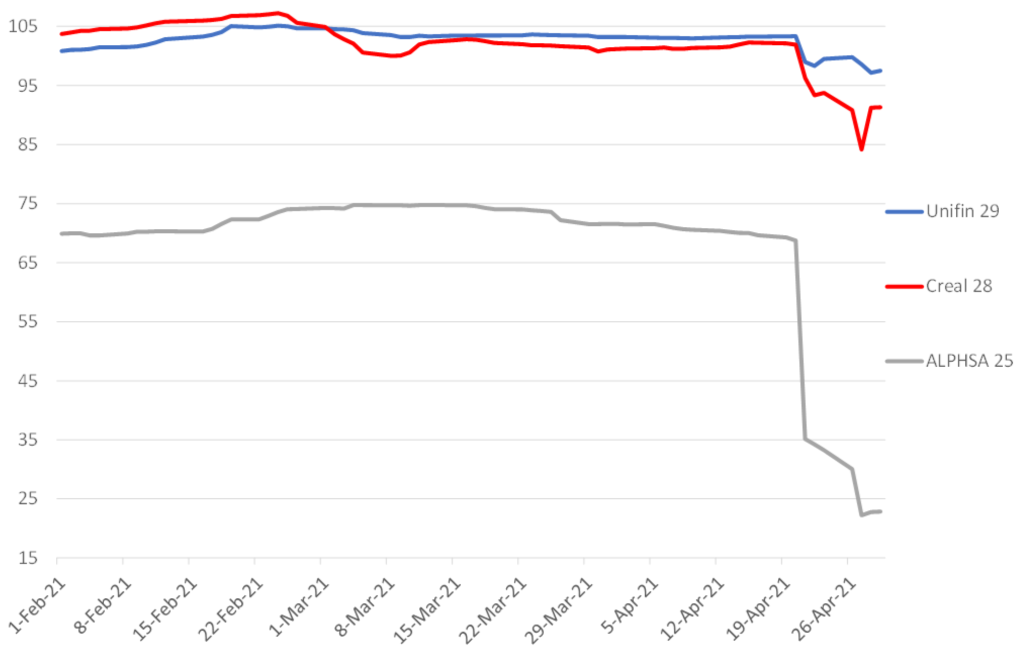
Alpha Credit (Caa2/CCC/CC), a Mexican non-bank financial services provider, said it anticipates there will be an impairment of a majority of the MXP 4.1 bln ($206 mln) reported as other assets and other accounts receivable in the company's previous balance sheet. This figure exceeds the company's capital (MXP 2.8 bln in 3Q20), which dropped last year already.

A restatement was necessary, as the company's current auditing firm announced its intention to make corrections in the company's 2018-2019 accounting for its derivative positions. The errors related to the company's: (i) allowance for loan losses; (ii) reserves for certain accounts receivables; and (iii) amortization of certain capitalized expenses.

The issuer suspended publication of the full year 2020 financial statement, scheduled to be released at the end of April. Should all errors relating to reserves for certain accounts receivables be approved, Alpha Credit will face a capital shortage. At the end of 3Q21 the company's capitalization ratio, measured as common equity relative to managed assets, was as low as 13%. The capitalization ratio (at least 13.5%) that consists of total stockholders' equity divided by total gross loan portfolio is one of the covenants on the Eurobond issue placed in early 2020 (ALPHSA 25). If all errors relating to reserves for certain accounts receivables are approved, the ratio will fall below the thresholds of loan covenants and bondholders will have the right for an early call on bond payment. The two dollar Eurobonds issues account for over 80% of the company's debt. Alpha Credit is a medium-sized player in the Mexican and Colombian financial services market (assets were $1.1 bln as of 3Q20). The company focuses on loans with payment via payroll, or PDLs (92% of the total portfolio) and factoring and leasing services offered primarily to small and medium-sized enterprises (SME).

The issue ALPHSA price tumbled by over 50% and all three international rating agencies downgraded the company to 'CCC', signalling further downgrades. The negative effect of AlphaCredit's statement spilled over to other sofoms, dragging down Unifin (BB-/BB), Credito Real (BB/BB+) and Findep (B+/BB-). Pressure mounted, as Credito Real increased the size of its non-performing loan portfolio at the end of last year from 1.8% to 3.3% (following reclassification of unserviced debt to defaulted debt).

MEXICAN SOFOM DOLLAR NOTES ISSUES



Source: Bloomberg

HOW JUSTIFIED IS THE SELL-OFF?

In the case of Alpha Credit, whose notes maturing in 2025 fell to a pre-default level of 22%, it is very difficult to draw firm conclusions . Obviously, the ongoing corporate events distressed the market which hasn't reversed its decline so far. The issuer hasn't provided any additional information to investors since then, so nothing is known about the timing of the restatement and the duration of the work of the special committee (made up of members of the board of directors, independent advisers, legal advisers and auditors). The positive scenarios include approval of a smaller amount of reserves and/or additional capitalization of the company by its shareholders (similar to that of 2020, when Softbank injected $100 mln into the company). As for two other high-profile issuers in the EM universe - Unifin and Credito Real - we believe the market overreacted. Since the start of the sell-off both companies have released IFRS financial statements for the first quarter of 2021, suggesting that their credit quality is not exposed to any major risks.

Credito Real - 1Q21 performance was expectedly weak, but the market was preparing for the worst After the company said last weekend that is adjusted its 2020 annual statement to show an almost 100% increase in its non-performing loan portfolio, the prices of its Eurobonds tumbled (the longest issue, Creal 28, face value plummeted more than 20%). Ahead of the publication, investors didn't rule out a more dramatic plunge in asset quality since the beginning of 2021. However, the published figures didn't shock the market that much, and the bonds quickly reversed almost half of the losses. Thus, the share of relief loans declined further from 5.2% to 2%. The relief loan programme is expected to be discontinued soon. The total loan portfolio continued to grow (+9% qoq) amid active growth of payroll loans (accounting for about 58% of the total portfolio). Overdue debt in the payroll this segment is expected to increase, but still looks very moderate (NPL 1.7%). The SME segment looks the weakest (23% of the portfolio), as its asset quality deteriorated sharply (NPL 12% vs 0.5% a year earlier), and new bank lending declined. The overall quality of loans has materially decreased over the past two quarters, the share of "overdue" loans grew from 1.8% to 3.9%. At the same time, in absolute terms, these figures do not carry serious risks to the company's credit profile and do not stand in stark contrast to the sector's average.

The earnings still remain under pressure amid continuing relief programmes and higher cost of funding (11.2% on average in 1Q21 vs. 9.4% in 4Q20). As a result, the net interest margin (NIM) fell to 10.4%. Net income declined 26% quarter over quarter (about $5 mln in January-March 2021).

Equity as a share of liabilities is declining smoothly, but is not yet a concern (22%). The capitalization ratio (equity/total portfolio) is estimated at 31.4%.

CREDITO REAL SELECTED IFRS FINANCIALS

$, mln	1Q21	2020	9M20	2019	2018
Assets	3879	3 542	3356	3262	2520
Cash	21	55	18	62	29
Equity	865	814	807	851	810
Loan Portfolio	2608	2397	2202	2487	1847
Total Debt	2859	2504	2368	2200	
Net profit	5	38	30	103	102
ROAA	0.5%	0.6%	1.1%	3.6%	4.3%
NIM	10.4%	11.5%	11.8%	17.1%	20.8%
NPL ratio, %	3.9	3.3	1.8	1.3	1.7
Coverage ratio	117%	225%	217%	220%	173%
Equity/Assets	22%	23%	24%	26%	32%

Source: Company data

Unifin bonds decline was mostly driven by the market's overreaction and is not justified from the financial profile standpoint. Another Mexican non-bank lender, Unifin, also recently reported 1Q21 results. Overall, the results look moderately positive. Loan origination is gradually picking up, reflected in an increase in the leasing portfolio. The payment discipline of the borrowers does not decline, thus the overdue debt ratio for the entire portfolio is almost unchanged (NPL 4.9%). Just as in Credito Real's case, profitability of operations is still under pressure due to the reduction of new bank lending in the previous reporting periods and ongoing relief programmes (now 5% of the total portfolio). Net interest margin fell to 6% (6.4% at the beginning of 2021). The share of capital in liabilities is stable at 15%). The capitalization ratio (equity/total portfolio) is estimated at 21.5%.

UNIFIN IFRS SELECTED FINANCIALS

$, mln	1Q21	2020	2019
Assets	4288	4 283	4 184
Cash	234	186	250
Equity	661	671	577
Loan Portfolio	3203	3 226	3 035
Total debt	3398	3 289	3 333
Net profit	15	64	101
ROAA	1.5	1.50%	2.80%
NIM	6%	6.40%	7.30%
NPL ratio, %	4.9	4.8	3.7
Coverage ratio	86%	72%	61%
Equity/Assets	15%	15%	14%

Source: Company data

OUR TAKE

The volatility seen in Mexico's non-bank lenders' market over the last week was driven by errors in financial statements of a small industry player (Alpha Credit is a third of the size of Credito Real by assets and almost fourth of the size of Unifin) and is largely unjustified, which is reflected in the companies' fresh financial reports and absence of warnings from international rating agencies. We recommend considering buying Eurobonds of Unifin, as their allure improved in terms of risk/return ratio after the recent decline. The company's business model is fundamentally different from that of Alpha Credit (the main focus is on leasing, not retail financing). The company's recent 1Q21 IFRS statement also reflects its credit profile stability and acceptable asset quality. According to the comments made by senior executives during the 1Q21 earnings call, the financials released are accurate and fully reflect the current financial state of the company. The pandemic-induced problems are thought to be gone away. Our recommendation for the most undervalued Unifin 29 issue (YTM 10.46%) is BUY. Our recommendation for the Credito Real Eurobonds is HOLD.

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