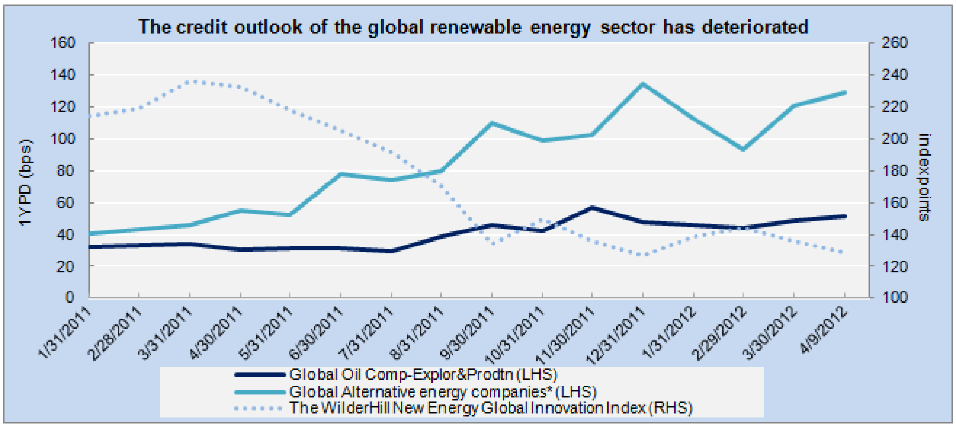
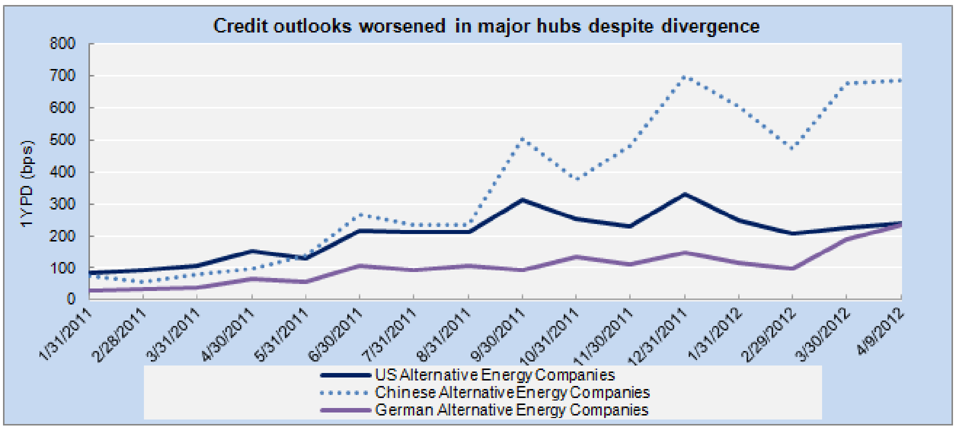
Stories of the Week

Global renewable energy sector facing strong headwinds while regional imbalances deepen

The renewable energy sector has become a popular national strategic interest worldwide in the past decade and has seen rapid capacity growth. However, the sector currently finds itself in an increasingly harsh business environment. Last year the industry witnessed steep losses and a plunge in industry-wide stock prices (see the WilderHill New Energy Index in the first graph below), led by prominent players such as Suntech Power and First Solar from the solar power industry, as well as Goldwind from the wind power industry. Major casualties of the industry slump include Solyndra, a US solar power company which declared bankruptcy last September despite USD 527mn in federal loan guarantees, and German solar-cell maker Q-Cells which filed for insolvency on April 3. The surge in company failures in the renewable energy sector reflected increasingly hostile business realities, arising from ongoing financial market turbulence, policy risks and a weakening global economy, at odds with the sector's ambitious expansion plans. Due to these threats, the credit outlook for the global renewable energy sector is negative. According to RMI CRI data, the sector's 1-year probability of default (PD) on April 9 remained elevated compared to its readings for most parts of last year. We have also noticed a widening gap in credit risks between the renewable sector and the oil exploration and production sector since 2011, reflected through PD movements, as the more established oil sector benefited from recent increases in the price of crude oil while many companies in the nascent renewable energy sector were struggling to establish cost effectiveness and business viability.



One significant factor contributing to the industry woes is oversupply, an issue which is particularly prevalent in the Chinese solar and wind power sectors, and has spread to other countries as Chinese companies expanded overseas. This has created fierce competition among producers, leading to aggressive pricing practices that have significantly eroded profit margins. Intense competition has not only caused losses for producers in the developed world, but also harmed the bottom line of Chinese companies. This has led to a significant deterioration in the industry's credit outlook, particularly in China, as noticeable jumps in the RMI CRI 1-year PD during 2011 illustrate. Looking ahead, the Chinese government continues to be committed to promoting the sector's development under its economic rebalancing plan, offering subsidies and making investments in the sector. This could further augment competition in the industry and in turn impair the profitability and credit outlook of incumbent firms in the renewable energy sector.



The credit outlook for global renewable energy companies is increasingly influenced by changes in government policies. European-based companies are facing a large decline in government subsidies, as governments cut expenses to offset weakening finances. For example, the German government cut incentives for solar projects on March 30, and the Italian government significantly reduced subsidies for renewable energy companies on April 2. Across the Atlantic, government support for US renewable companies is also increasingly at stake despite President Obama's persistent calls for support for the sector. Solyndra's failure last September bolstered attacks on the renewable energy sector by Republicans who question the worthiness of extending government financial support in the form of loan guarantees. These recent moves suggest a growing trend in Western countries, which contrasts sharply with the situation in their eastern counterparts, potentially fuelling imbalances in the industry across these regions.

Lastly, financing conditions for renewable energy companies remain challenging. As the protracted European debt crisis increases investor risk aversion, renewable energy companies, which still largely rely on government subsidies and deploy expensive new production and technologies, may lose investment appeal and find private funding increasingly costly or difficult to attain. However, signs emerged this year that the ability to obtain funding is expected to show variances across regions. European companies are expected to experience a sharp drop in liquidity, while companies in developing regions are still seeing robust growth in investment. One recent example is a USD 600mn investment in renewable energy companies by Denham Capital Management, a US private equity firm, announced on April 5. Brazilian companies are expected to receive a significant portion as the fund's key investment market.

Future changes in the credit risk of the global renewable energy sector is expected to be driven by the aforementioned factors. The sector, which was once was a favourite of governments across the world for energy security, environmental and economic benefits, is facing heightened uncertainties and risks. On balance, the sector's credit outlook is downbeat while regional differences will be reinforced by global political and economic forces.

*Alternative energy is another term for renewable energy.

Sources:
Q-Cells Files for Insolvency as Solar Bankruptcies Rise (Bloomberg)
Suntech sees solar industry back in black in H2 (The Times)
Solyndra Bankruptcy May Blunt Obama's Renewable Energy Drive (Bloomberg)
Goldwind profits hit by Chinese grid issues, local competition (Recharge)
Renewable energy country attractiveness indices (Ernst &Young)
Catching the wind: China slows growth of wind-power sector (Want China Times)
China to Promote Renewable Energy Through Subsidies (WSJ)
Global renewable energy market faces challenging times (Ernst &Young)
Should the EU give up on green energy? (Globalpost)
Bundestag votes in favour of solar incentive cuts (Pv-tech.org)
Italy to cut renewable energy subsidies (United Press International)
Obama pledges new efforts on clean energy (Channel NewsAsia)
Denham Earmarks 20% of $3 Billion Fund for Renewable Energy (Bloomberg)
Summit discusses alternative energy (The Gulf Times)

In the News

Spanish debt yields and Italian yield spreads rose, Portugal sold 18-month T-bills
Apr 4. Spain has come to the forefront of investors' concerns as the amount of funds raised was at a lower end of the target range and borrowing costs surged at an auction last Wednesday, following an announcement that the country will overshoot its original deficit target of 4.4% for year 2012. EUR 2.6bn of Spanish debts were auctioned; bonds maturing in 2012 were sold at a yield of 5.3%, higher than the yield of 5.15% at a previous Spanish auction last September. In a contrast, market sentiment improved in Portuguese markets, as the country sold EUR 1bn in 18-month Treasury bills on April 4, the longest-term loan since its bailout last year. The bill was auctioned at 4.53% which is roughly the same rate as it is paying on bailout funds. Meanwhile, in the secondary market, Italy's 10-year bond spread over German bunds widened last week after the Italian prime minister made concessions to trade unions over a planned labor market reform. (Reuters, Bloomberg)

Downgrades Could Limit Investment Pool for Money-Market Funds
Apr 6. Money-market funds are facing the risk of having less investable debt securities due to Moody's current rating review of 17 global and 114 European financial institutions. The review, which is expected to be concluded by the middle of May, puts the credit ratings of many of these financial institutions at risk of a downgrade. Should it happen, money-market funds, which only buy highly-rated bonds, will not be able to purchase debt issued by downgraded companies. Anticipating this, a number of money-market funds have reduced the duration of their exposures to the financial institutions on rating watch, and sought other investment vehicles such as US government debt and non-financial commercial paper. (WSJ, CNBC)

EU credit rating reforms caused ECB concerns, finance ministers agreed on reconsidering reform
Apr 4. The European Central Bank (ECB) expressed concern about aspects of a third round of EU Regulations for credit rating agencies (CRAs), proposed by the European Commission's Financial Services Commissioner Michel Barnier on November 15 2011. The ECB called for a revision of some of the proposals, citing the potential negative impacts of current proposals, in particular overstated credit ratings as a result of increased industry competition. The ECB statement followed an agreement by EU finance ministers a week earlier to rethink a plan requiring rotation of the CRAs issuers use. However, the ECB supported a proposal that will increase the frequency of CRA sovereign rating reviews, and requires CRAs to provide more information on sensitive sovereign credit rating changes. (Reuters, Bloomberg)