Credit profile of Malaysian oil and gas industry worsens amidst heightened profitability woes

by Elaine Uy

- **NUS-CRI Agg 1-year (median) PD shows the worsening credit health of the Malaysian oil and gas industry as oil and gas services providers contend with diminished cash flows and poor profitability**
- **Sapura Energy's financial turmoil and debt restructuring exemplifies troubles in the Malaysian Oil & Gas sector as other vulnerable firms in the sector may face a similar fate**

On 10th March 2022, the High court of Malaysia granted one of the country's high-profile oil-field services providers, Sapura Energy Bhd (Sapura[1]), a scheme of arrangement (SOA) that allows the company to negotiate with its creditors and vendors to restructure its debt. The mounting pressure on the company's profitability[2] and liquidity levels amidst the COVID-19 pandemic severely impacted its credit health, as can be seen by the uptick in NUS-CRI 1-year PD that had skyrocketed since August 2021 prior to the commencement of its debt restructuring in Mar-2022 (See Figure 2a), shortly after the company had refinanced its MYR 10.3bn debt due to its diminished liquidity position. With Sapura's default, the overall credit health of the Malaysian oil and gas industry also comes into the foreground considering the notable increase in the NUS-CRI Aggregate (median) 1-year PD of the industry, which surged by close to 40bps to 120bps in Mar-2022. Going forward, the NUS-CRI Agg Forward 1-year PD (Forward PD[3]) implies that the credit outlook of the sector may potentially improve on the back of government support.

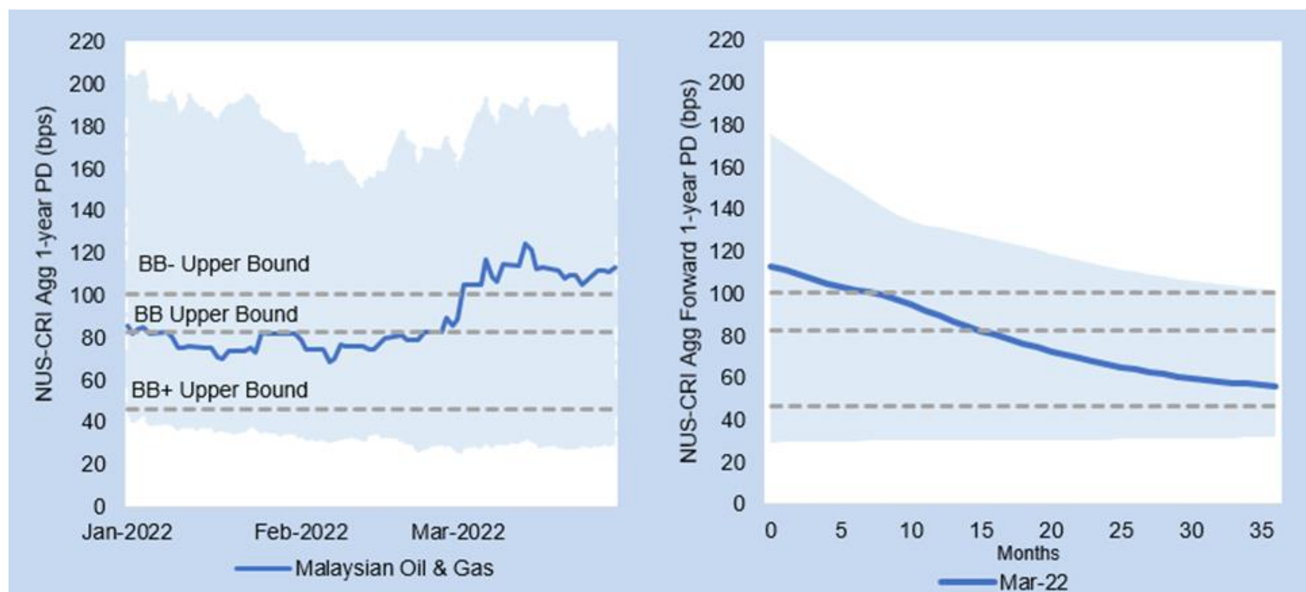

Figure 1a (LHS): NUS-CRI Agg 1-year PD of Malaysian Oil & Gas companies, with their interquartile range, from Jan-2022 to Mar-2022 with reference to PDiR2.0 bounds[4]. Figure 1b (RHS): NUS-CRI Agg Forward 1-year PD for Malaysian Oil & Gas companies, with their interquartile range, with reference to PDiR2.0 bounds. *Source: NUS-CRI*

[1] Sapura Energy Bhd is an integrated oil and gas services and solutions company

[2] The group has been incurring hefty losses over the past 3 years, with the most recent loss as of FY2022 amounting to MYR 8.9bn notwithstanding the MYR 4.1bn revenues.

[3] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months – this is conditional on the firm's survival in the next 6 months.

[4] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

The Malaysian oil and gas industry appears to have benefited from the soaring oil prices, especially as Petroliam Nasional Bhd (Petronas), the country's largest oil producer, finished FY2021 with a 30.24% profit margin. However, the Malaysian Oil & Gas Services Council (MOGSC) emphasized that, unlike Petronas, the other oil service companies[5] in the industry performed poorly with negative cash flows. These other companies that provide services and equipment to companies such as Petronas, were asked to lower their rates in 2015 to support the oil and gas industry when the oil prices crashed. Even when the industry recovered and oil prices stabilized, the rates remained the same[6]. Given these dynamics, it seems that the other companies are subsidizing companies like Petronas, with the latter reaping the benefits of the favorable conditions in the market at the former's expense[7]. The poor profitability of the other oil and gas companies had put a severe strain on their cash flows, requiring them to take on leverage to be able to continue providing services and meet their working capital needs. This arrangement puts the other firms at a disadvantage as they anticipate an increase in capital expenditure, potentially fueled by debt financing, to transition into greener activities to align with the government's shift towards sustainable energy and to remain in compliance with environment-centric policies. In the worst-case scenario, these vulnerabilities might put them on the same trajectory as Sapura.

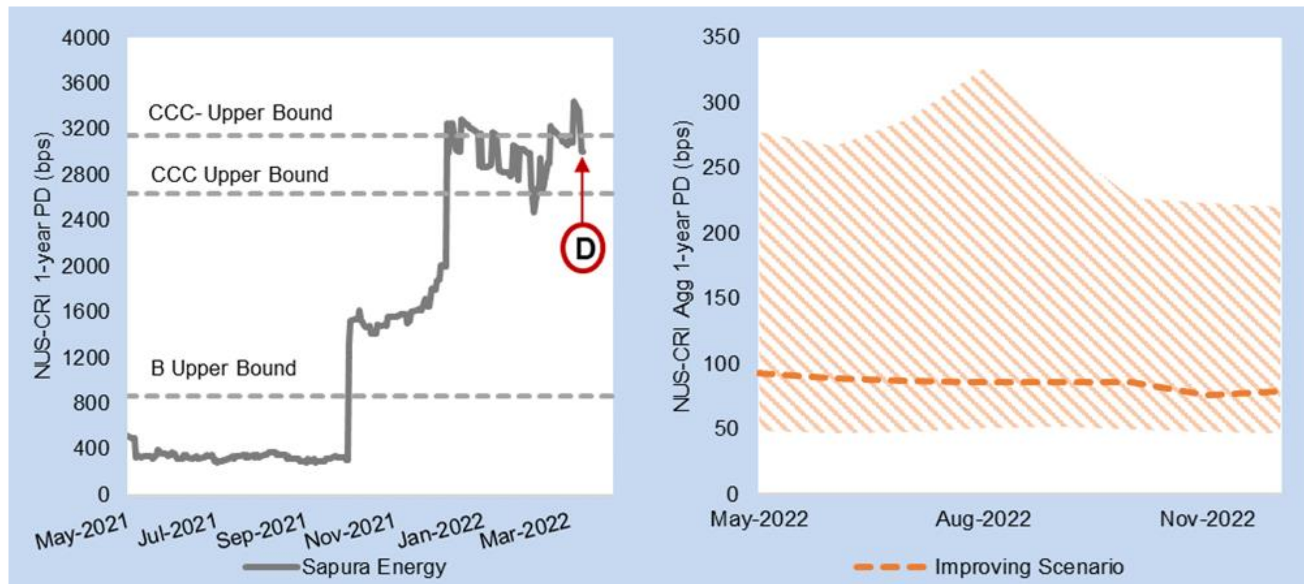

Figure 2a (LHS): NUS-CRI 1-year PD of Sapura before default in Mar-2022 with reference to PDiR2.0 bounds. Figure 2b (RHS): Stressed NUS-CRI Agg 1-year PD with interquartile range based on improving credit conditions for the Malaysian energy sector. *Source: NUS-CRI, BuDA v3.3.0*

Sapura's credit woes started several years ago when the oil price crashed in 2015 and was magnified by the excessive risks they had assumed, such as acquisitions and bidding of projects with onerous terms. As of FY2022, Sapura's accumulated loss stood at MYR 13.51bn (close to 80% of its asset value) despite the oil price rally, as it had to contend with the high financing costs from its legacy projects. Additionally, Sapura had to recognize massive impairments from its idle[8] oil rigs, which had to be scrapped following more stringent safety requirements. Sapura's unsustainable borrowing practices are underscored as its debt ratio surged to 98.43% in 2022[9] with the majority of the debts being demandable in the short term. Another symptom of the liquidity problem of Sapura was its inability to pay a subcontractor prompting its customer, India's state-owned Oil and Natural Gas Corporation, to intervene. In 2018, Permodalan Nasional Bhd had injected cash into Sapura by taking up unsubscribed rights shares, propelling its holdings by 28 percentage points up to 40%. Notwithstanding the lifeline, Sapura couldn't turn its operations around. And with the recent developments, amidst the cloud of the 1MDB financial scandal, the government is faced with yet another dilemma of bailing out a heavily indebted company. Further, with Petronas also denying any current plans on acquiring Sapura's strategic investments and assets, the long-term benefits for Sapura's operations due to their choice to opt into a debt restructuring remains to be seen.

[5] Includes oil services companies like Sapura, which are subcontractors and vendors to large companies, that account for 60% of the industry.
[6] Similarly, charter rates for offshore support vessels remained at the discounted level that is 35% lower than it was before the crash, forcing them to operate at a loss.
[7] As per the MOGSC, the losses of publicly listed oil & gas services companies amounted to MYR 6.7bn in the period of 2020-2022.
[8] These assets had been idle beyond a reasonable period without any firm prospects or operators, as demand has been hit by business curbs to contain the spread of the COVID-19 surge prompting major producers to cut outputs.
[9] Debt ratio had been steadily hovering around 60% from 2018 to 2021.

Should credit conditions and access to credit for Malaysian Oil & Gas companies improve in the near future, the impact on the industry's credit risk can be measured using stress tests conducted by the NUS-CRI Bottom-up Default Analysis toolkit (BuDA[10]). The stress tests to judge the improving credit conditions are judged based on the credit cycle index (CCI) of Malaysian energy companies returning to pre-pandemic levels. As seen from Figure 2b, Median stressed PD improves marginally by 10-15bps, while the impact on non-vulnerable firms remains relatively negligible, possibly suggesting that these companies' credit profile is not hampered by current credit conditions. Vulnerable firms (those that have PD higher than the upper quartile), tend to not benefit from improving credit conditions in the short-run, suggesting that their underlying financial position is deteriorating regardless of the industry's credit environment; but do benefit near the latter part of the testing period, possibly as continued improvements in the credit environment may reap improvement in their credit profile should they survive the initial deterioration in their financial position.

While the series of events leading up to the default of Sapura adversely affects the Malaysian oil and gas industry ecosystem, it also emphasizes the symptoms that may have already been prevalent in the industry, albeit undetected due to its high degree of fragmentation. As such, the recovery of Malaysian oil and gas companies depends heavily on government intervention in the form of bailouts, financing channels, incentives for industry-wide consolidation, and possibly the introduction of legislation to protect revenue streams. The government may potentially nudge state-owned firms like Petronas to step in and acquire other vulnerable players in the process of improving the credit outlook of the industry as a whole over the next few years, should the industry face further distress, which may lower the credit risk outlook of the whole industry (See Figure 1b).

[10] The Bottom-up Default Analysis (BuDA v3.3.0) is a credit stress testing and scenario analysis toolkit jointly developed by the Credit Research Initiative (CRI) team of National University of Singapore (NUS) and the International Monetary Fund (IMF).

Credit News

Wall Street banks detail Russia losses and warn of more volatility

Apr 15. Wall Street banks disclosed the extent of potential losses stemming from the Ukraine war, while at the same time warning that the market would continue to see a prolonged period of volatility. Although the losses disclosed remain small when compared to revenues and also are much lower than the exposures of their European peers, expectations are that the banks face bigger headwinds from a potential recession brought on by disruptions in the commodity market. The banks' investment banking divisions also saw a double-digit decline in profits as the impact of war caused clients to postpone issuances. For some banks, losses in the investment banking division were offset by gains in the trading business. (FT)

European firms shift more of their debt towards ethical goals

Apr 12. Because of increasing pressure from regulators and exchanges to disclose environmental, social, and governance activities, firms have been ramping up their sustainability-linked financing facilities, that is, issuing debt either for green uses or tied to ESG targets. These movements make green facilities more visible and accessible to the public, thus facilitating and furthering the implementation and achievement of ESG goals. Overall, European corporate loans with ESG targets have increased to 26% from only 19% in 2021. Roughly 70 companies in Europe have at least two of their core financing facilities tied to sustainability goals. (Bloomberg)

War and inflation set to drag on corporate profits despite rising revenues

Apr 17. With the biggest companies in the US poised to report 1Q earnings in the coming weeks, wider market expectations are of a slowdown in earnings growth due to surging inflation and an adverse impact of the Russia-Ukraine war. Going forward, inflation promises to be a significant headwind for most companies. Most of the 26 companies which have already reported results, almost 60% have pointed to labor costs and shortages affecting margins. Additionally, expenses linked to the pandemic and supply chain issues have also hurt earnings. Analysts expect companies in the S&P 500 index to register an average year-on-year EPS growth of 5.2%, which is the slowest pace since the last quarter of 2020 and a sharp slowdown as compared to the 32% growth seen last quarter. (FT)

Canada's rate hikes jeopardize housing boom

Apr 14. Canada's economic recovery is linked to real estate, which contributes 20% of its GDP growth. However, since residential investors typically want to avoid high borrowing costs, this means that any movement in interest rates would have an effect on the country's economic growth. This attribute makes it especially challenging for the Bank of Canada to decide on the appropriate monetary action to keep rates at a level that is favorable enough for the housing market to flourish, but also high enough to curb the rapidly growing inflation. Although as a contingency, the Bank of Canada can turn to immigration to fill the housing supply in the wake of higher borrowing costs. The government had accepted over 400,000 immigrants last year and is targeting another 800,000 immigrants over the next two years. (WSJ)

Ukraine war deepens debt woes across developing world

Apr 17. Many low-income countries are finding it increasingly difficult to service foreign debt due to tougher conditions brought on by the fallout of the Ukraine war, soaring inflation, and rising interest rates. The IMF is concerned about the growing debt crisis as the proportion of low-income countries exhibiting distress had already increased to 60% in 2020 from only 30% in 2015. These nations have accumulated debt until the pandemic to service unexpected costs only to be met with another economic shock. As such, combined global borrowing jumped to 256% of 2020 GDP, which is borrowed not only from the IMF but also from China and other private companies who were looking at earning good returns in a low-interest rate market. Rates offered by these lenders may not be as friendly and could mimic market rates, adding to the financial burden of distressed nations. (WSJ)

Inflation surge slashes $11tn from world's negative-yielding debt (FT)

Bond rout promises more pain for investors (WSJ)

Uniqlo owner warns of big profit drop in China due to Covid-19 curbs (FT)

Regulatory Updates

China cuts banks' reserve rules in effort to combat economic impact of Covid

Apr 15. In an effort to stimulate the economy, China's central bank reduced the reserve requirement of banks by 25 basis points. Policymakers however sought to keep the main interest rate unchanged as an aggressive easing may result in capital outflow. The move to reduce reserve requirement would free up USD 78bn of capital, allowing banks'' to increase lending. However, as the economy struggles with COVID-19 lockdowns and increased restrictions, the positive impact of these steps is highly unlikely due to a lack of demand in the economy. Banks' have also demonstrated an unwillingness to lend in such a situation as there is a higher chance of payment defaults. (FT)

ECB says Ukraine war is pushing up prices but sticks to gradual response

Apr 15. PBOC has reduced the amount of reserves that banks must hold to boost credit lending and economic recovery amidst a fresh slew of COVID-19 lockdowns. In tandem, the central bank has chosen not to reduce rates to ensure that capital outflow, especially to the US, which is beginning to raise rates, is limited. The cut in reserve requirement is expected to increase the amount of lending activity in the economy by CNY 500bn, though analysts estimate that lackluster demand, due in part to the ongoing COVID-19 crisis, may mitigate the intended impact of this policy change on the economy. As such, the move to cut rates is being seen as a minimal effort by the PBOC to ensure that the economy remains buoyed despite exogenous shocks to the economic recovery. (FT)

Singapore dollar rallies after central bank ups inflation fight (Bloomberg)

Yen falls to 20-year low as Bank of Japan holds fast to stimulus pledge (FT)

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