Russia's oil firms display relatively low credit risk compared to US and OPEC producers

by Sean Lau & Anthony Prayugo

The oil price war between Saudi Arabia and Russia in tandem with the COVID-19 outbreak drove the Brent oil price to a 21-year low in April. This increased the credit risk of many oil producers as they are now faced with lower profits, tighter cash flows and greater refinancing needs. In our March Weekly Credit Brief Issue, we looked into how the oil price war and the COVID-19 demand destruction affected the credit quality of US oil producers. In this issue, we will revisit the situation with a greater focus on Russian oil companies, particularly on how they are coping with the low oil prices compared to their US and OPEC counterparts. The latter comprises mostly of countries in the Middle East and Africa.

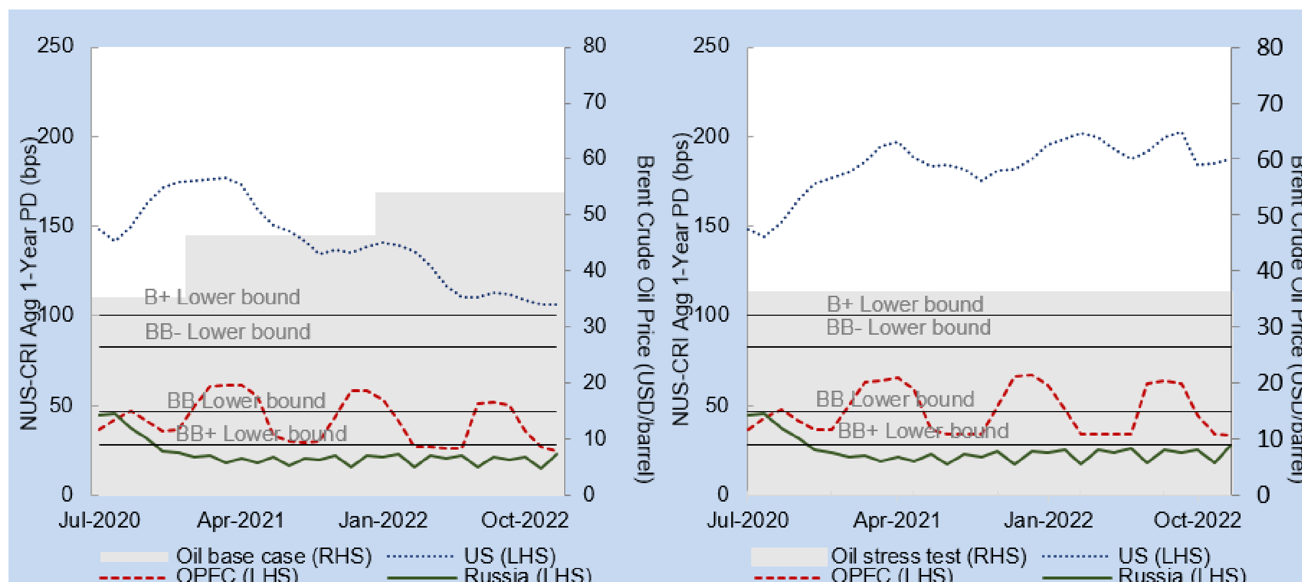

Figure 1: Predicted development of US, OPEC and Russian oil producers' Agg (median) PD for the next 2 years based on the base case (LHS) and stress test (RHS) scenario with reference to PDiR2.0[1] bounds. *Source: NUS-CRI*

The Bottom-up Default Analysis (BuDA[2]) toolkit was used to simulate the effects of different possible Brent crude oil price scenarios to analyse their impact on the Probability of Default (PD) of oil companies in Russia, OPEC countries and the US. The assumptions for oil price are categorized into a base case and stress test scenario. For the base case scenario, the oil price forecast by Deloitte was used. The forecast predicts that oil price will initially remain at USD 35/barrel this year before gradually increasing to reach USD 54/barrel by the end of 2022. As for the stress test scenario, we assume that the oil price will remain at USD 35/barrel until the end of 2022. Therefore, as we can see in Figure 1, the PD of Russian oil companies is expected to remain relatively low in both scenarios when compared to their US and OPEC counterparts. In comparison, the PD for US and OPEC

[1] 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.

[2] The Bottom-up Default Analysis (BuDA) 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).

companies looks to remain elevated if the oil prices remains depressed for a prolonged period. There are several reasons that have attributed to this effect.

Firstly, the Russian government has developed a system to protect the country's domestic producers from price shocks. The system when entering a low oil price environment, goes into self-preservation mode with government tax lowering with the oil price. This helps reduce the cost of production for oil producers. In addition, by allowing a floating exchange rate, as opposed to Saudi Arabia who pegs to the US dollar, Russia has been able to limit the damage done domestically. The Rouble's depreciation allows Russian oil to continue being attractive to their European and Asian importers due to the more favourable exchange rate. These 2 measures of lowering tax and a depreciating exchange rate support the profitability of Russian firms and allow their PDs to stay relatively lower than their oil exporting competitors.

Another reason for the Russian firm's relatively low PD is due to the limited debt exposure of Russian firms with the state controlled Rosneft and Gazprom making up 90% of the sectors net debt. Given the capital-intensive nature of the industry, Russian firms still have the lowest total debt to total equity at 19.7% when benchmarked against the US and OPEC which are at 58.4% and 64.6% respectively. Furthermore, if required, government has enough reserves to finance its state-controlled companies. This is due to Russia having a strong fiscal position with more than USD 500bn of reserves including more than USD 100bn in its National Welfare Fund reserves. The National Welfare Fund stores the extra revenue collected by the government when the oil price was above USD 40 in preceding years. In comparison, the US oil and gas industry faces a debt problem. As of March 2020, the sector had about USD 86bn of rated debt due in the next four years of which about half was due in the next 2 years, according to Moody's. With most of this debt being junk rated, this could expose companies to challenges in refinancing their debt.

Russia oil companies are also relatively more profitable compared to their US and OPEC counterparts. Currently, the median profit margin of Russian firms is 13.0%, higher than their US and OPEC peers which are currently standing at -6.1% and 3.6% respectively. This is because Russian oil companies have a relatively lower production cost as compared to their foreign competitors. For instance, the average break-even price of Russia oil companies is around USD 9-10/barrel, lower than the average break-even price of US shale oil which is approximately USD 50/barrel. While Saudi Arabian oil companies have an even lower cost of production, many other OPEC member countries still have relatively higher break-even prices and their respective governments have weaker fiscal profiles. This might explain why OPEC oil companies have historically entailed a higher credit risk when compared to Russian oil firms (see Figure 2).

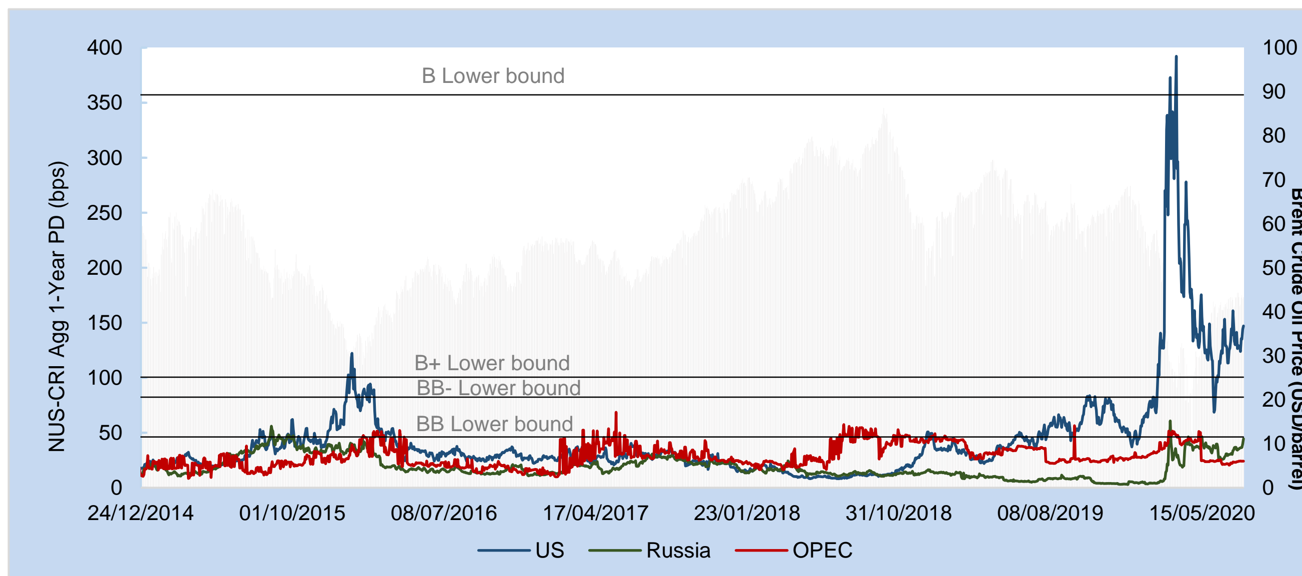

Figure 2: NUS-CRI Aggregate 1-year PD (Agg PD) for publicly listed oil producers in the US, OPEC and Russia from 2014 with reference to PDiR2.0 bounds. *Source: NUS-CRI*

Fundamentally, Russian firms have a strong business and financial position in the oil industry as reflected in their lower Agg PD. However, there remains the political risk associated with the country and its oil industry. In addition, there have been many sanctions levied on Russian oil industry over the years, the latest being the country's state-owned company Rosneft getting sanctioned by the Trump administration for transporting Venezuelan oil to Asia in February. Further sanctions on Russian firms and the industry will drive up the cost of doing business and cause Russian firms to lose revenue. It could also have an indirect impact on the firms if the Russian government faces financial pressure.

There is also the fear that this price war has accelerated the long-term trend of many nations to shift towards renewable energy. With solar and wind energy having zero variable cost once constructed, this crisis has represented an attractive opportunity for countries to shift towards this trend. This is especially true in the European market where renewables now account for 44% of total power generated in the European Union in Q2 2020, up from 37.2% last year. With Europe being Russia's largest regional importer of oil, this could represent a long-term reduction in the demand for oil and greatly affect companies' future profits. The short-term credit outlook for Russia's oil firms looks to remain stable regardless of the oil price recovery. However, in the long term, the country will have to continue to innovate and achieve diplomacy with other nations to ensure the continued good credit health of the oil industry.

Credit News

More businesses will tap Fed loan program if economy worsens, Rosengren says

Aug 8. A key Federal Reserve official stated that participation in the Main Street Lending program would expand rapidly if the pandemic worsens. The Main Street Lending Program administered last month by the Boston Federal Reserve has received criticism on being too restrictive and too late in the crises, with many commission members questioning the program's efficiency. So far, 509 financial institutions have signed up with the program, but only 153 of them were willing to be part of lenders that are accepting new borrowers through the program. (Reuters)

Corporate bond investors still wary of coronavirus volatility

Aug 7. The Covid-19 pandemic brought about a spike in volatility. The yields of Investment Grade corporate bonds are relatively higher than the following costs of insurance within the derivatives markets. This presents with investors the ability to earn returns while hedging their risks by going long on cash bonds and short on derivatives that are of the same credit. The larger investors would prefer to trade in derivatives like the credit default swaps which are usually more liquid. (WSJ)

Foreign holdings of Chinese bonds rise in global chase for yield

Aug 6. Overseas institutional investors have increased their renminbi-denominated bond holdings to CNY 2.5tn in Jun 2020 from CNY 2tn a year earlier. This phenomenon follows the "return of growth in Q2" of the world's second-largest economy while other countries continue to struggle with the pandemic. Furthermore, the aggressive quantitative easing in the US and Europe has provided relatively more attractive yields in the Chinese markets to yield-starved investors. The Chinese 10-year sovereign debt now offers an additional yield of almost 2.5 percentage points over US Treasuries. (FT)

Alphabet locks in record-low borrowing costs in USD 10bn deal

Aug 4. Alphabet issued USD 10bn in bonds at the lowest borrowing cost ever for a US company. Prior to the issuance, the company had only USD 4bn in outstanding debt. The double A-plus rated company's USD 2.25bn 10-year bond sold with a coupon of just 1.1%. Alphabet's new five- , seven- and 30-year bonds also set record low coupons, with Alphabet's five year bond costing a quarter of a percentage point above US cost of funds at 0.45%. The Fed support in the market through QE and other tools, including a commitment to directly purchase investment-grade bonds came after the sell-of in Mar 2020. This has prompted a flood of capital inflows into the market and allowed companies to issue record amounts of debt, at significantly cheaper rates. (FT)

Foreign hunger for US credit isn't sated

Aug 4. Despite the yields on US corporate bonds beating former lows, the market for US credit remains attractive for foreign investors. Specifically, for Japanese and European investors who are able to hedge their currency exposure, the real return of US corporate bonds remains attractive in a yield starved credit market. However, this trend might not prevail should the spreads on the US corporate debts fall in the long run. (WSJ)

Lowest mortgage rates ever spur historic jump in bond supply (Bloomberg)

Airline SAS secures more debt holder support for key part of rescue deal (Reuters)

China central bank to allow Baoshang to file for bankruptcy (Reuters)

Regulatory Updates

China central bank says it will make policy more flexible and targeted

Aug 6. China's central bank would make its prudent monetary policy more flexible and targeted, and maintain adequate liquidity to support economic recovery. The People's Bank of China (PBOC) would maintain a reasonable growth in the money supply and total social financing to meet the demand for loans from enterprises to support economic recovery. Furthermore, it also believes that further easing in monetary policy and stimulus measures may trigger market bubbles. The macro leverage ratio is expected to gradually return to a reasonable level, after allowing the debt level to climb over the last few months. However, non-performing loans could rise due to the coronavirus crisis. China will also stabilize land prices and property market expectations, with the PBOC specifically highlighting that it would not use the housing market as a tool for short-term stimulus in the markets. (Reuters)

Negative rates in BoE toolbox, but no plans to use them, BoE's Bailey says

Aug 6. The Bank of England (BoE) stated negative rates remain to be part of its toolbox despite having no plans to cut interest rates below zero for now. This follows after BoE cut interest rates to 0.1% in March while increasing its bond-buying plan to USD 1tn. The BoE expected that the economy will not return to its pre-pandemic level until the end of 2021. However, short-term predictions are less grim as the unemployment rate is lower than it was previously estimated. (Reuters)

UAE central bank relaxes rules on liquidity, funding for banks (Business Times)

Brazil central bank cuts rates, sees little or no room for more (Reuters)

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Contributing Editor: Yao Xuan