CRI Credit Research Initiative
Risk Management Institute, National University of Singapore
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transforming big data into smart data
Weekly Credit Brief
Dec 05 - Dec 11

Energy and coal companies on track to end 2017 with the highest credit risk

by Dexter Tan

2017 was a year characterized by stronger than expected economic growth as many countries, for example, Germany and Singapore expanded at their fastest rate in years. The IMF is expecting world growth rates to increase from 3.2% in 2016 to 3.6% in 2017 and possibly exceed 3.65% next year. Growth in emerging and developing markets is also projected to surpass 4.58% this year and reach 4.9% in 2018. The pickup in economic strength coincided with an improvement in the CRI's measure of global corporate credit quality as financial and borrowing conditions, particularly in large economies remained easy and accommodative.

Our survey of 31,880 publicly listed firms across 72 industries shows that 62 industries witnessed an improvement in their aggregate credit profile between Dec 31, 2016 and Dec 8, 2017. The RMI-CRI aggregate 1-year Probability of Default (PD), a median of PDs for all listed firms started the year at 9.19bps and gradually declined to 6.69bps in October, the lowest level in more than two decades before increasing slightly to 7.11bps on Dec 8.

The RMI-CRI default probabilities forecast the credit risk of listed issuers and take into account macro financial factors and firm specific attributes including its level of cash and net income to total assets. After approaching its peak of nearly 50bps in November 2008, the RMI-CRI aggregate 1-year PD for all listed firms has largely been on a downward trend over the past few years, suggesting an improved credit outlook.

Our analysis of RMI-CRI aggregate 1-year PDs across industries shows that coal companies are on track to finish the year with the highest sectoral default risk, despite falling from the level at the end of 2016. During the year, the RMI-CRI aggregate 1-year PD for oil and gas service companies exhibited an upward trend, rising from 25bps at the end of 2016 to 28.3bps on Dec 8. The default risk for globally listed banks increased slightly during 2017 as lenders in certain economies remain saddled with high non-performing loans. Although increased demand and higher earnings led to stronger credit fundamentals within the shipbuilding and alternative energy industries during the year, their 1-year PDs are ranked among the highest in the world.

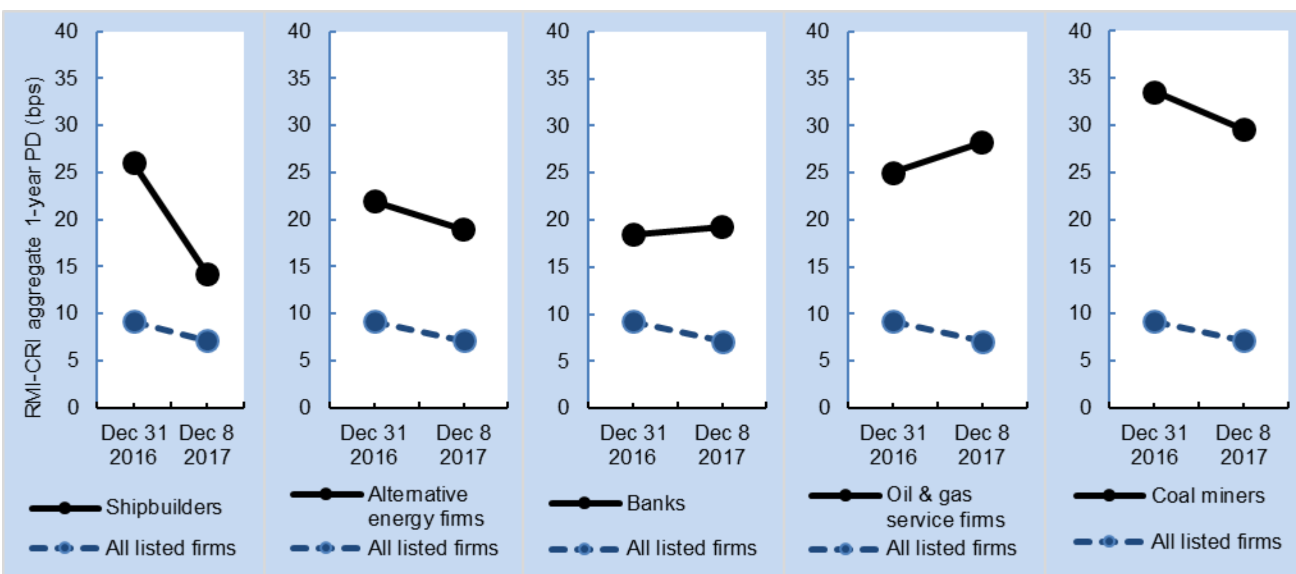

Figure 1: Top 5 industries with the highest aggregate 1-year PD on Dec 8. *Source: RMI-CRI*

Underlying these credit performances and what is perhaps a common theme among these high PD sectors is their high dependence on energy prices, with the exception of banks. Members of OPEC (Organization of the Petroleum Exporting Countries) agreed to production cuts through next year but oil prices continue to remain low in the midst of a global glut of crude. High yield bond issues within the oil and gas service industry have increased significantly this year and the sector's larger debt burden indicated a slightly higher credit risk. Demand in the world's biggest consumer of coal, China, has increased this year, but US utilities are also shutting coal fired plants at a rapid pace and shifting to cheap natural gas. The downturn in commodities has led to a decline in global shipping trade, along with losses and restructurings among shipbuilders.

The pace of above-trend economic growth may extend into the first half of 2018, especially in the US as personal and corporate tax rate cuts may create higher consumer and investment spending. Corporate credit could continue to remain healthy as revenue growth rates offset margin pressures from rising wages. Central banks are preparing to shift from adding liquidity to financial markets to withdrawing their monetary stimulus, which may create periods of short term interest rate volatility. That said, the broader risks to growth are perhaps geopolitical, ranging from military tension in the Middle East to a war on the Korean peninsula.

Credit News

Four Seasons in crunch talks over debt deferral

Dec 11. Four Seasons, a care home operator, is likely to avert the risk of missing a debt repayment of GBP 26mn due on December 15 by agreeing an extension with its largest creditor, H/2 Capital Partners. Although the deferral negotiation is still ongoing, it is highly likely that H/2 Capital will agree to this crucial deferral of debt repayment to next year. Four seasons has struggled under a debt burden of GBP 525mn, which stems from the acquisition of the business by its owner, Terra Firma. Due to rising costs of labor and government cuts, Four Seasons has come under huge operating pressures, making this health care sector hard to repay the interest. Even missing the payment this week would be unlikely to push the business into administration owing to a 30-day "grace period". (FT)

Investors told to brace for the steepest rate hikes since 2006

Dec 11. Economists are cautioning investors to be prepared for the biggest tightening of monetary policy in a decade as the world economy is headed for strong growth. The average interest rates across advanced economies is forecasted to climb by at least 1% next year as global expansion becomes sufficiently strong to spur inflation. However, concerns remain on whether this tightening could possibly derail demand. Central banks around the world will announce their final policy decisions of 2017 this week and the Fed is predicted to raise the Fed rate by 25bps. Despite the tightening, global interest rates are still low by historical standards and tightening measures may halt if inflation remains weak. Policy makers are still finding the balance between controlling inflation and encouraging growth. (Bloomberg)

Philippines wins Fitch upgrade in boost for Duterte's plans

Dec 11. Fitch Ratings raised the rating on Philippines' long-term foreign currency-denominated debt to BBB with a stable outlook, providing an endorsement of President Rodrigo Duterte's economic plans, which included a tax reform aimed at cutting most income taxes while raising levies on fuel, sugar and car purchases in order to boost revenue. Such a rise in revenue could help spur infrastructure spending and underpin the economic expansion of Philippines, which is set to remain one of the fastest expanding in Asia, with growth of 6.8% next year and in 2019. Investor sentiment has also remained strong, as evident from solid domestic demand and inflows of foreign direct investment. However, Fitch Ratings warned that the economy's strong growth raises the risk of overheating due to a widening trade deficit and rising leverage. (Bloomberg)

China audit finds provinces faked data and borrowed illegally

Dec 10. In a nationwide audit, China found some local governments inflated revenue levels and raised debt illegally, after a run of data fraud that has been widespread in some of the poorer provinces where officials were incentivized to inflate the numbers in order to advance their careers. According to a statement issued by the National Audit Office, ten cities, counties or districts inflated fiscal revenues by RMB 1.55bn, while five cities or counties raised about RMB 6.43bn in debts by violating rules, such as offering commitment letters. These findings were a blow to China's attempts to curb data fraud, attempts included setting up a new supervisory body within China's statistics office to bolster and ensure data authenticity and quality, shifting to the latest United Nations-based statistical standard, and using computers rather than local reports to calculate provincial gross domestic product. (Bloomberg)

Steinhoff seeks to defuse accounting scandal

Dec 9. Steinhoff International Holdings is to assign three board members to keep a closer eye on corporate governance as the response to an accounting scandal that has wiped out EUR 11bn of the company's market value. An investigation is underway to uncover details behind the scandal that has resulted in an 84% drop in share price in three days. Christo Wiese, the billionaire and largest shareholder of the company, has seen his wealth plummeted since the scandal broke. His net worth is now USD 1.8bn, down from USD 4.4bn in early December. Steinhoff said on December 7 that it was considering to boost liquidity by selling assets worth at least EUR 1bn. (Bloomberg)

Egypt's economy rebounds as inflation drops, inflows rise (Bloomberg)

Gunmaker shares slide as 'fear-based buying' recedes (FT)

Boston Herald files for Chapter 11 bankruptcy protection (WSJ)

Regulatory Updates

Global bank battle over Basel III finally concludes

Dec 7. A compromise has been reached between opposing European and US views to agree on the new banking rules governing lenders. The agreement is the last outstanding item in the Basel III package. Previously, contention between US and European officials revolved around measuring the riskiness of lenders. Internal models used by European banks had been criticized as overly optimistic by US officials, while European officials claimed that the US proposals were unfairly disfavouring European banks. The compromise was to allow banks a certain degree of leeway in using their own risk models and a 72.5% floor was set to limit the usage of internal models in computing risk-weighted assets. The amount of capital held by banks against souring loans is expected to increase under this arrangement. (WSJ)

IMF calls on China banks to boost capital after credit boom

Dec 7. The IMF has called on China's banks to strengthen their capital buffers beyond what Basel III requires in order to fortify themselves against the risk of an economic shock. The latest IMF assessment included stress tests of 33 Chinese banks, of which 27 were under-capitalized relative to what would be needed in a high-stress scenario, while noting that capital was adequate at the "Big Four" state-owned lenders. IMF praised Chinese authorities for implementing the Basel III standards on bank capital while calling for additional buffers to absorb potential losses that can be expected during the economic transition. IMF also points out that it is obvious that Chinese authorities are shifting policies away from pursuing expansion at all costs to focus instead on high-quality and less-risky growth, but the speed and effectiveness of this policy shift remains uncertain. (FT)

UK financial watchdog's fines increase tenfold (FT)

Mortgage banks in firing line as Basel readies capital rules (Bloomberg)

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Contributing Editor: Victor Liu