Indonesian coal industry shows lower credit risk than Australian peers amid stronger financing and slow renewables shift

by Alyssa Alexandra Harijanto

- **The Indonesian and Australian coal industries have demonstrated stable credit profiles in 2021, as indicated by the NUS-CRI Agg 1-year PD, on the back of strong earnings driven by soaring coal prices**
- **The NUS-CRI Agg Forward 1-year PD shows the lower and stable credit outlook for the Indonesian coal industry compared to the worsening credit outlook of its Australian peers due to differences in access to financing and the pace of transition to renewables**

COP26 in November brought back to the limelight the ongoing shift to renewable energy to replace coal. This casts a spotlight on the two largest exporters of coal globally, Indonesia and Australia, both of which have greatly benefited from the recovering demand for coal and surging raw material prices this year. The NUS-CRI 1-year Aggregate (median) Probability of Default (PD) demonstrates a stable credit profile this year for both the Australian and Indonesian coal industries as they remain below the BBB- Upper Bound when referenced to PDiR2.0[1] bounds (See Figure 1a). However, looking forward, the NUS-CRI Aggregate (median) Forward 1-year PD (Forward PD[2]) shows a diverging credit outlook of the Australian and Indonesian coal industries. The Forward PD for the Australian coal industry increases nearly tenfold, surpassing the BB- Upper Bound, while that of the Indonesian coal industry remains relatively flat at 30bps in the long term (See Figure 1b) as the industry receives stronger financing and faces a less rapid change in the energy landscape compared to that of Australia.

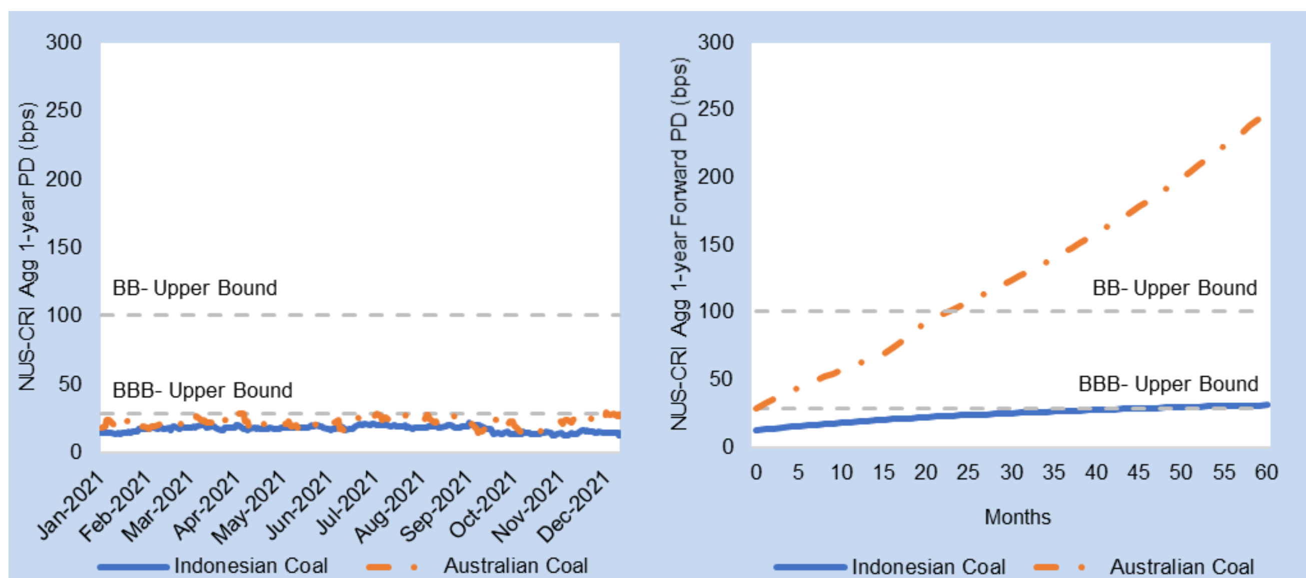

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Indonesian Coal and Australian Coal industry from Jan-2021 to Dec-2021 with reference to PDiR2.0 bounds. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Indonesian Coal and Australian Coal industry as of Dec-2021 with reference to PDiR2.0 bounds. *Source: NUS-CRI*

Due to the rapid global economic recovery from the pandemic this year, coal demand has soared as countries ramp up construction and power generation. The surge in coal demand has pushed global coal prices up (See

[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 Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar 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, conditional on the firm's survival in the next 6 months.

Figure 2a), greatly benefiting both coal exporters, Australia and especially Indonesia. The jump in Indonesia's export volume between 2020 and 2021 (See Figure 2b) is mainly driven by rising Chinese demand, whose imports of Indonesian coal in September increased by 89% from a year ago. The strong earnings have allowed the Indonesian coal industry to reduce its total debt to capital ratio from 26.3% in Q1 2021 to 16.3% in Q3 2021. Similarly, Australia has also recovered the absence of Chinese imports by ramping up its exports to India, Japan, South Korea, and Taiwan, hence keeping its export volume stable. As the debt pressure for Indonesia remains lower than Australia, whose total debt to capital ratio only marginally decreased from 21.6% in H1 2020 to 20.8% in H1 2021, the future credit risk for the Indonesian coal industry appears lower and more stable compared to its Australian peers (See Figure 1b).

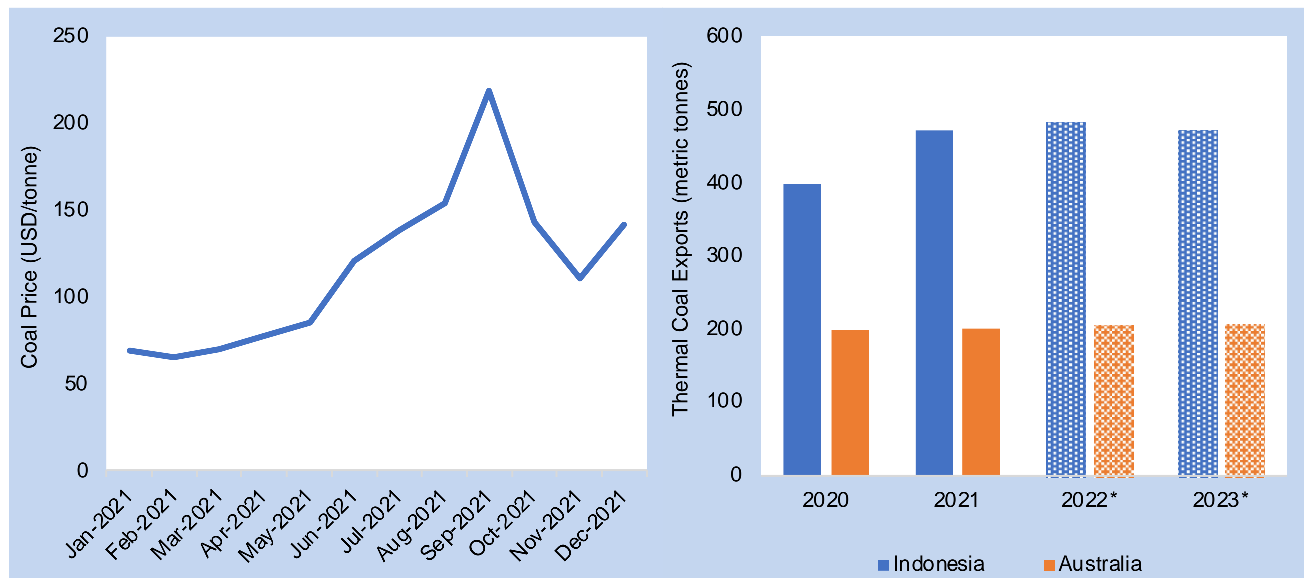

Figure 2a (LHS): Monthly spot price of coal in USD/tonnes. Figure 2b (RHS): Actual and projected thermal coal exports for Indonesia and Australia in metric tonnes from 2020 to 2023. * denotes forecasted value. *Source: Markets Insider; Department of Industry, Science, Energy, and Resources*

However, the global push to adopt green energy sources and reduce emissions is beginning to threaten the coal industry. Earlier this year, the three biggest importers of Indonesian and Australian coal – China, South Korea, and Japan – have each announced their commitments to reduce carbon emissions and end funding of coal-fired power projects abroad. As these three countries account for over 95% of total foreign financing of coal-fired plants since 2013, this decision would cut off a major chunk of future financing for coal expansion plans for both Indonesia and Australia, forcing them to search for alternate funding sources. This could explain the upward pressure on the future credit risks of both the Indonesian and Australian coal industries (See Figure 1b). On the bright side, the commitments by the three countries are not expected to affect the demand of Indonesian and Australian thermal[3] coal exports in the near term, as the coal export volume is projected to remain stable until 2023.

Despite the commitments by the three countries to halt overseas coal finance, currently, the Indonesian coal industry may still enjoy adequate access to foreign financing. According to the Global Energy Monitor, Indonesia still has over USD 2bn in ongoing[4] overseas financing for domestic coal projects from Japan and China. Additionally, despite China's tough stance on coal, following its energy crisis in October, the Chinese government stated that coal-generated power is likely to stay for a relatively long time, with the country's coal demand projected to peak in 2025. Considering that Indonesia has replaced Australia to become China's largest overseas supplier of coal due to China's embargo on Australian coal imports since Dec-2020, it is likely that China's demand for Indonesian coal would be sustained until at least 2025. This could translate to continued financing from China in the future, given that China has always been one of the major financiers in the Indonesian coal industry with over USD 15bn in investments, nearly half of total foreign funding received by the country. This is reflected by the relatively stable credit risk of the Indonesian coal industry looking ahead (See Figure 1b).

[3] Thermal coal is used in power generation, which is generally considered to have a more adverse impact on the environment compared to metallurgical coal used in steelmaking and is less replaceable than thermal coal.
[4] Financing is in progress or is set to be completed at a future date.

In contrast, the Australian coal industry faces a major headwind[5] in the form of shrinking access to financing and insurance, especially as the Big Four[6] banks have tapered lending to coal firms. This shift away from coal by the banking sector could mean higher borrowing costs moving forward for the capital-intensive industry. While Asian lenders, particularly Chinese banks, have played a bigger role in financing the Australian coal industry compared to local banks, they may pull back their support for the industry if local banks are not involved in financing local coal projects. Due to dwindling domestic and foreign financing[7] options, the industry may see their expansions being hindered in the future and having to rely on their own finances to fund their operations, which could deteriorate their cash flow positions, as seen by the steep upward trend of the Forward PD of the Australian coal industry (See Figure 1b).

Domestically, the Indonesian government has been pushing for the development of coal gasification to boost demand for the commodity should key importers taper their coal usage. In October, a Chinese company invested USD 560mn in coal gasification plants in Aceh, followed by a USD 15bn investment by US-based Air Products and Chemicals to develop a coal gasification industry in the country. These investments would lock in demand for Indonesian coal in the coming decades, which would ensure a consistent future revenue stream for the industry.

Another major difference in the outlook of the coal industry for the two countries is the pace of transition to renewable energy. The renewables scene is more developed in Australia, making up 24% of total electricity generation as opposed to Indonesia's 12%. According to the Australian Energy Market Operator, the nation's coal-fired power plants are likely to shut almost three times as fast, as the country anticipates a ninefold increase in wind and solar power by 2050. This would translate to a declining market share for coal in Australia's energy mix and hence threaten the profit-generating capabilities of coal firms. In contrast, the Indonesian government has subsidies that make coal very cheap domestically, therefore reducing the incentives for the entry of renewables in the country. Moreover, Australia appears to be stepping up the development of its green financing market. As of 2020, Australia has issued USD 21.9bn in Green, Social, and Sustainability (GSS) themed debt as compared to USD 5.9bn by Indonesia. The easier access to the sustainable financing market could incentivize Australian corporates to accelerate their shift to renewables as opposed to Indonesian corporates, thereby threatening the local coal industry.

While both the Australian and Indonesian governments still demonstrate support for their respective coal industries, currently Australia faces mounting pressure both internationally and domestically through its financial institutions to stop using coal and accelerate the transition to renewable energy, mainly because the country has the financial capabilities to do so. In comparison, Indonesia has said that it would be able to phase out its coal-fired power plants and transition to renewables only if the country gets significant financial assistance from the international community. As economic development and poverty reduction are the Indonesian government's priorities over emission reduction, there are still strong incentives for the use of coal as it remains the cheapest source of power in the country, which bodes well for the local coal industry. While their strong earnings could help them navigate through short-term financial woes, looking ahead, the Australian coal industry seems to face bigger financing hurdles and a more rapidly changing demand landscape compared to Indonesia.

[5] For further details regarding headwinds faced by the Australian coal industry, please refer to the WCB published earlier this year.
[6] Australia's Big Four banks refers to the four largest banks by market capitalization: Commonwealth Bank of Australia, Westpac Banking Corporation, ANZ, and the National Australian Bank.
[7] Global Energy Monitor shows there is no ongoing foreign financing for Australia's coal projects.

Credit News

Biden extends student loan payment pause another 90 days

Dec 22. In light of the surge in cases of the Omicron variant of COVID-19, President Biden has agreed to extend the pause on student debt by an additional 90 days. The pause, which started in Mar 2020, was scheduled to expire by the end of Jan 2022. The Education Department said in a statement that the pause would allow them to assess the impact of the variant on the repayment ability of student borrowers. An approximate 43mn people hold a cumulative student debt of USD 1.6tn, an amount which is higher than credit card and auto debt. (WSJ)

Global bond markets on course for worst year since 1999

Dec 25. The Barclays global aggregate bond index has achieved a negative return of 4.8% so far in 2021, owing to two periods of heavy selling in government debt. Earlier this year, investors dumped longer-term government bonds, betting that the recovery would bring in a time of steady growth and inflation. In the autumn, when central banks signaled interest rate rises, shorter-dated debt took a beating. Despite 2021's losses and the prospect of central banks tightening monetary policies next year, it is too early to call time on the 40-year bull market in bond. Longer-term yields peaked in March and have since declined. The recent strength of long-dated debt indicates investors worry too quickly tightened policy will derail the economic recovery or trigger a stock market sell-off. (FT)

European banks prepare for pullback in ECB stimulus

Dec 22. Issuance of covered bonds recently rose to the highest monthly level since pre-pandemic times, as banks lock in super-low borrowing costs ahead of possibly tighter monetary policy in 2022. Globally, corporate debt issuance has remained strong. Banks sold EUR 20.8bn worth of bonds in September and EUR 13.6bn in October. The European Central Bank announced last week that the special conditions of its targeted long-term refinancing operations (TLTRO), such as favorable interest rates, are expected to end in June. As such, more issuance of covered bonds are anticipated in 2022 to repay the TLTRO. Higher than expected inflation could force the ECB to tighten monetary policy earlier, with debt markets signaling that the central bank may have to act more forcefully. Spreads have begun to widen in the corporate debt market as investors anticipate less demand from ECB purchase programs and price at risk from the Omicron variant. (WSJ)

China developers hit by record rating downgrades after Evergrande crisis

Dec 22. Chinese property developers have been hit by record numbers of downgrades from international credit rating agencies this year, as Evergrande's collapse fuels concerns over the health of China's economy. The downgrades come after the introduction of measures last year to cool an overheating property market and a liquidity crisis that is threatening to spread to more trusted borrowers. Moody's, Fitch, and S&P downgraded Chinese developers' ratings 43, 54 and 30 times, respectively, in 2021, compared with 6, 12 and 11 in 2020, adding further pressure on their ability to refinance offshore debt during a slowdown in the housing market. Amidst China's slowing economy, land purchases have slumped, and new home prices have fallen MoM for the past three months. Of the biggest borrowers, while riskier developers were subject to significant downgrades in the past year, the ratings of investment-grade companies were largely unchanged. (FT)

US financial conditions remain easy as Fed pulls back on stimulus

Dec 23. US financial conditions remain near the most accommodative on record. US stocks have stayed buoyant around record-high levels, while yields on US Treasuries are persistently low. The stimulus is now set to end by March, and an earlier end to taper allows the Fed to raise interest rates sooner. Although the Fed plans to reduce its asset purchase program more quickly, financial conditions would remain accommodative, as investors bet that the hikes in interest rates won't be as much as the Fed hoped if economic growth slows more than expected. Moreover, the accelerated taper of Fed purchases, potential rate hikes, and tight financial conditions will translate into significant volatility in credit and equity markets. (FT)

Riskier corporate debt beats blue chip bonds as Fed pulls back stimulus (Bloomberg)

Oracle's cerner purchase prompts a trio of debt-downgrade warnings (Bloomberg)

Eyeing IMF deal, Zambia asks creditors to evaluate debt proposals (Reuters)

Regulatory Updates

China's central bank vows greater support for real economy

Dec 25. China's central bank pledged greater support for the real economy, with more proactive use of monetary policy tools and more forward-looking and targeted monetary policy. The PBOC has so far taken a restrained approach to monetary stimulus, but expectations are growing that it will do more in 2022, especially if property market problems and slowing private consumption continue. Policymakers have also reiterated they will keep liquidity reasonably ample and make credit growth more stable and keep the debt-to-gross domestic product ratio steady to stabilize the economy. The PBOC will also implement re-lending programs that support small businesses and companies in reducing emissions. Analysts expect more easing to come next year, including further cuts to the reserve requirement ratio and a potential reduction in policy interest rates. Authorities also signaled more fiscal support in early 2022 to drive investment and infrastructure building. (Bloomberg)

Turkish banks hiked rates in race for lira deposits

Dec 27. In what could be a surprise for borrowers expecting cheaper credit, Turkish banks raised rates in a race to attract lira deposits in reaction to the government's new lira-defense scheme. On Monday, President Tayyip Erdogan announced that the government would protect local depositors against foreign exchange losses, leading to an aggressive rally in the lira. The lira had plunged on Monday to an all-time low of 18.4 to the dollar following a months-long slide due to Erdogan's policy of unorthodox rate cuts and fears of an inflationary spiral. In response, bond yields and corporate loan rates instead rose as traders predicted a policy U-turn. Banks raised rates even more to build up lira reserves in the face of rising funding costs and still-high dollarization. Rates on deposits jumped to more than 20%, from 17-18% a week ago, while rising funding costs pushed SME loan rates to more than 30%, making long-term business loans increasingly expensive and hard to find. (Reuters)

Independent watchdog to oversee UK insolvency sector (FT)

Europe's over-complex bank rules increase risk, watchdogs warn (FT)

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