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Weekly Credit Brief Feb 02 - Feb 08

A review of credit quality across global sectors in 2015

by Dexter Tan

In this weekly credit brief, we highlight the credit performance of sectors worldwide in 2015. We surveyed a portfolio of 29,600 firms and looked at their RMI-CRI 1-year Probability of Default (PD) changes over the year. During 2015, 53 of the 69 sectors recorded a higher aggregate 1-year PD, which is a simple median of PDs in the sector. A higher PD reflects worsening credit quality. Only 16 sectors witnessed an improvement in credit profiles. Overall, 2015 was a year of market volatility and general pessimism, with a few dominating themes such as the prolonged strength in the US dollar and a sharp fall in commodity prices.

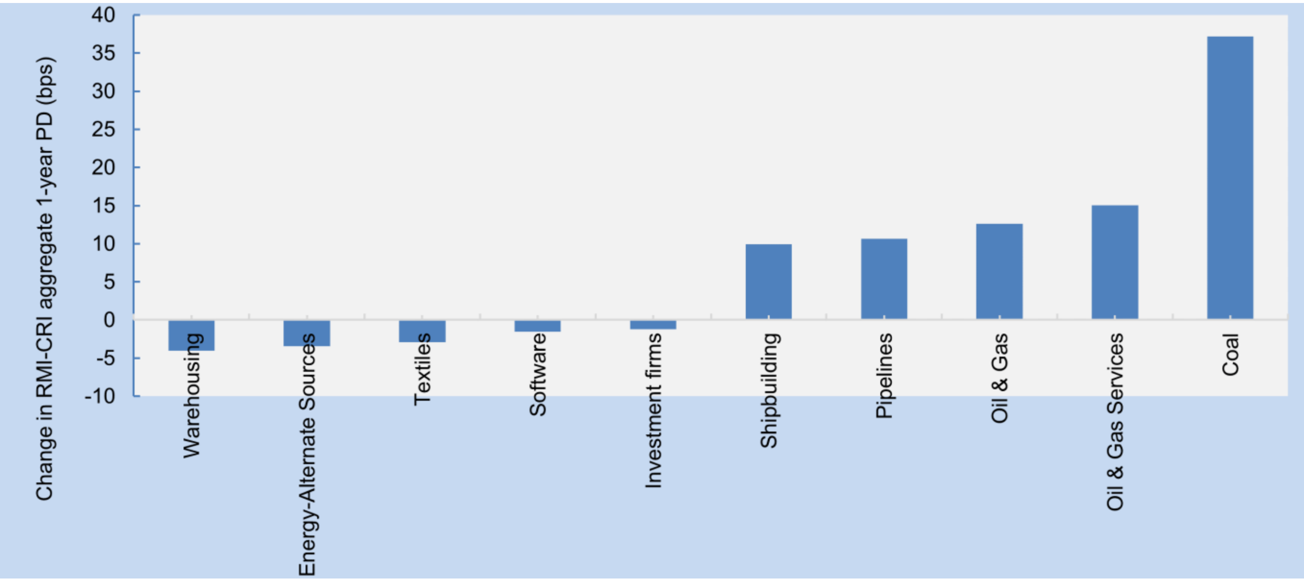

Figure 1: Top 5 best and worst performing sectors in 2015 based on the change of aggregate RMI-CRI 1-year PD. Only sectors with more than 30 firms were considered in our analysis. *Source: RMI-CRI*

The steep plunge in coal prices and reduced reliance on coal energy has significantly elevated the credit risk of coal companies. Prior to the Paris agreement on climate change in December, coal consumption was already falling. According to the Institute for Energy Economics and Financial Analysis, the adoption of gas-fired power stations, proliferation of renewable energy projects and expansion of pollution control regulation led to the financial distress of the sector. This was also reflected in the RMI-CRI 1-year aggregate PD for listed coal miners, which had been on an uptrend during 2015 (see Figure 1). In June, RMI-CRI highlighted two factors affecting the credit performance of US coal producers – the slowdown in the Chinese economy and the fall in natural gas prices.

There were a number of high profile defaults in the coal sector that left a bad taste on investors. Senior unsecured notes of Alpha Natural Resources paying 9.75% coupon due 2018, lost more than 90 percent of its value in 2015. The notes started trading at 46 cents on the dollar but fell to 0.25 cents a year later. Alpha Natural Resources filed for Chapter 11 in August as a result of collapsing demand and pricing of coal. Bondholders of Arch Coal's 7% 2019 notes, likewise, paid dearly for their investments after the bonds lost nearly 90 percent of their value. The former second largest coal producer in the US announced plans last month to compensate creditors with a combination of cash, new senior debt and equity stakes in the reorganized entity.

From a broader perspective, Standard & Poor's (S&P) estimated that a third of corporate defaults last year were firms in the oil, gas or energy business. Many oil companies over-borrowed during the oil boom years but could not pay back their creditors after oil prices and revenues nosedived. Concurrent with the ongoing defaults in the industry, the RMI-CRI aggregate 1-year PDs for oil and gas service firms increased from 19.47bps to 34.48bps. Of the 900 oil companies for which PDs were estimated, the number of firms with a 1-year PD above 35.52bps* had increased from 330 to 427. Samson Resource, which filed for bankruptcy in September, went on record as the issuer with the largest negative total bond returns in 2015, according to Bloomberg. Samson Resource's USD 2.25bn 9.75% 2020 bonds, lost 99.8 percent in 11 months, hurting investors like KKR & Co., who led the USD 7.2bn leveraged buyout of the oil and gas driller in 2011.

On a more positive note, the RMI-CRI 1-year PD for warehousing companies remained low through 2015, falling from 8.2bps to 4.2bps by December. Nearly half of the sector's constituents are domiciled in Japan while the rest of the firms are evenly distributed around the world. Interestingly, more than 70% of the sector has a market cap of less than USD 500mn but many have a RMI-CRI 1-year PD of less than 23bps. Mitsubishi Logistics Corporation, Japan's largest warehousing company, reported stable cash flows during the year, with revenue staying at JPY 52.3bn in Dec 2014 and JPY 52.6bn in Dec 2015. The company benefitted from the recovery of its real estate business as it redeveloped former warehouses into offices, while sales from the company's logistics arm continued to grow.

2016 is shaping up to be an even more volatile year than 2015, with many predicting a dreary scenario in the fixed income landscape. Fitch Ratings said that more sectors are likely to be downgraded this year, with the number of sectors with negative rating outlooks outweighing positives by approximately six to one. S&P held a similar view, stating that the potential rating downgrades exceeded upgrades by the most since 2009. As of December, S&P considered cutting ratings for 17 percent of the companies it covered. The RMI-CRI aggregate 1-year PD for global economies, meanwhile has reached the highest level since 2012, coinciding with the drop of the MSCI World Index, a weighted measure of market caps for globally listed companies.

*35.52bps is the RMI-CRI 1-year probability of default implied rating (PDiR) upper bound for S&P 'BBB' rated firms. The PDiR provides an intuition about what different values of 1-year PD from RMI's default forecast model imply about a firm's credit quality. The RMI-CRI 1-year PD for a firm is used to imply a credit rating based on historically observed default rates for credit rating agency ratings. The upper bounds for each PDiR are derived using S&P's historical default rates. These default rates were taken as the average one-year default rates from 2005-2014.

Credit News

China's debt default risk climbs to highest since June 2013

Feb 4. According to price data from CMA, the spread for credit-default swaps on Chinese sovereign debt widened to 140bps on Feb 3. The price of the contracts jumped by 19bps in January, the biggest hike in 16 months, while government notes continued to fall for a third week. Based on ChinaBond data, the yield on the benchmark 10-year notes has risen by 5bps to 2.89% as of Feb 4. (Bloomberg)

Deutsche "CoCo" bond prices fall to record low

Feb 4. The prices of Deutsche Bank's riskiest bonds plunged to their lowest level of all time. The high yields on CoCo bonds contributed to its performance as one the best performing asset class last year. However, demand for CoCo bonds has taken a significant hit this year, as investors hone in on the complications of new financial markets for bank debt. The unpopularity of these bonds is due to the possibility of cancellation of the high coupons on the bonds when the bank meets financial difficulties. Also, these bonds come with a call date, even though they may be perpetual. Finally, regulations also reduce the popularity of CoCo bonds, as regulators have the authority over the callback of these bonds, as well as influence over when the coupons are stopped. (FT)

US Treasury cuts sales of longer dated bonds

Feb 4. The US Treasury is cutting its issuance of longer dated debt in order to allow it to boost the supply of shorter-term bills. Issuance of five-, seven-, ten- and thirty-year debt will be reduced by USD 1bn each, resulting in a total USD 12bn reduction in bond issuance over the first quarter of 2016. The supply of bills compared to other debt maturities is at a multi-decade low, according to a statement from the US Treasury. At the same time, demand from investors is expected to grow due to reforms to money market funds that invest in short dated instruments. (FT)

China to relax foreign fund outflows limits

Feb 3. China's central bank plans to loosen rules for when foreign investors can bring money in and out of the country in a signal of its commitment to further open financial markets. Such changes would suggest that turmoil in China's stock market and the yuan's exchange rate haven't derailed plans by the People's Bank of China to further open the nation's capital markets to foreign investors, even as the authorities tightened restrictions for the local residents to move money abroad. (Bloomberg)

Natgas storage company Peregrine Midstream files for bankruptcy (Reuters)

Outer Harbor Terminal files for bankruptcy (WSJ)

UK boosted by SME lending growth (FT)

Regulatory Updates

Chinese central bank tests new money supply tools for Year of the Monkey

Feb 5. The People's Bank of China (PBOC) has been testing a new tool to reduce the need for deeper monetary policy easing. The PBOC introduced the new interest rate band to provide guidance on interest rates on loans and deposits. Using this new tool, the central bank sets upper and lower limits of the interbank rate band and uses short-term money market instruments to keep the rates within that range. Over the last three weeks, PBOC injected more than CNY 2tn into short-term funds to keep interest rates steady and within the recommended interest rate band. (Reuters)

U.S. regulators expected to classify more energy loans as high risk

Feb 3. With the fall in crude oil prices to a 12-year low, US regulators are likely to categorize oil and gas loans as high risk when they start a new bank portfolio review in early February. The Shared National Credit (SNC) review of bank loan underwriting standards is stepping up to twice a year in 2016 as regulators aim to crack down on lending practices that may pose systemic risk. According to Thomson Reuters LPC data, average bids on US oil and gas loans plunge to 76.6 on Feb 2 from recent peak of 92.8 last May. Bids in the overall leveraged loan market are at the lowest levels since Nov 2011, due to prospect of steep defaults and broad markets volatility. (Reuters)

Regulations for CRAs amended in Turkey (Lexology)

EBA to assess impact of IFRS 9 on EU banks (Lexology)

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