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Sri Lankan companies' PD may signal the trajectory of Pakistan's corporate credit outlook amidst a sovereign debt crisis

by Raghav Mathur

- **NUS-CRI Agg PD suggests that Pakistani companies' credit risk has steadily increased since the beginning of last year as the sovereign debt crisis trickles down into potential corporate distress**
- **NUS-CRI Forward PD suggests that Pakistani companies' credit risk outlook will worsen to levels similar to Sri Lankan companies at the height of the latter's debt crisis**

The governments of Pakistan and Sri Lanka are among the most distressed in Asia as a sovereign debt crisis in both countries continues to plague the credit risk outlook of their respective economies. The impact of the incumbent sovereign crises is also trickling into corporate credit health, with the NUS-CRI Aggregate 1-year Probability of Default (Agg PD) of both Pakistan- and Sri Lanka-domiciled corporates increasing over the last 12 months. Though Sri Lankan companies' Agg PD has relatively improved since its government proposed a restructuring of its USD 51bn external debt in Apr-2022, the NUS-CRI Aggregate Forward 1-year Probability of Default (Forward PD[1]) suggests that the short-term outlook for companies domiciled in both nations is negative, especially as borrowing costs rise and economic growth falters, impeding their access to financing. Given the overall similarity in the type of crisis faced by both nations, Forward PD suggests that it is likely that Pakistani companies' Agg PD is going to rise to a similar distress level in the next twelve months as that of Sri Lankan companies prior to Sri Lanka's sovereign default in May-2022.

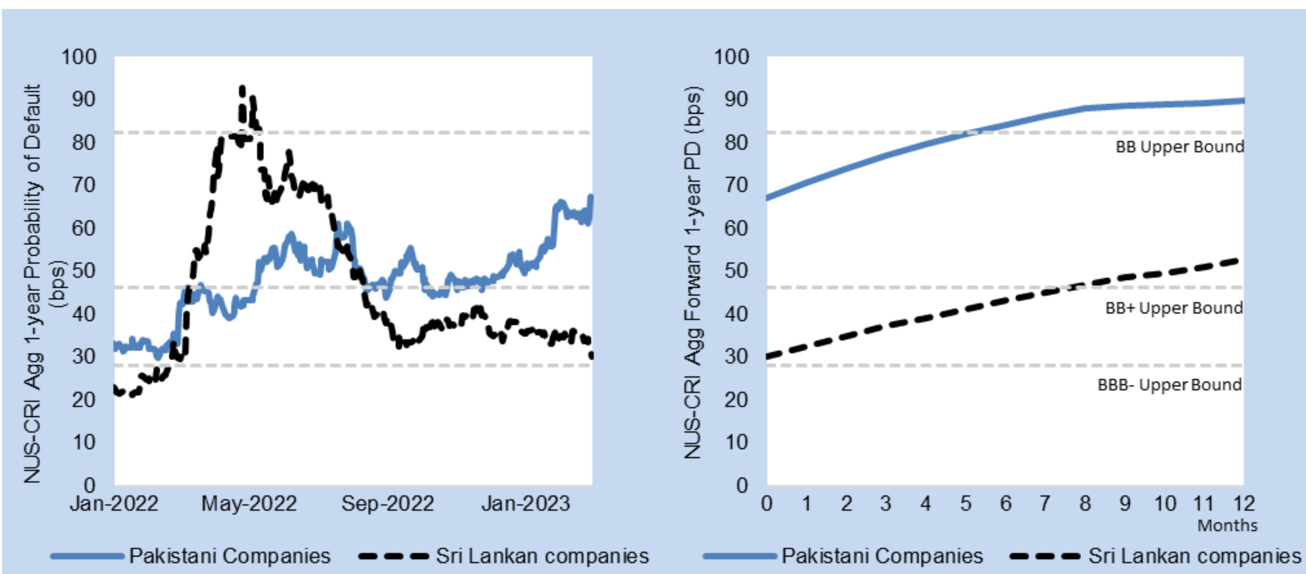

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for companies domiciled in Pakistan and Sri Lanka, with reference to PDiR2.0 bounds[2]. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for companies domiciled in Pakistan and Sri Lanka as of Mar-2023, with reference to PDiR2.0 bounds. *Source: NUS-CRI*

Pakistan's dwindling foreign reserves (See Figure 2a) have been contributing to the country's heightened inflation since last year. The country's headline inflation jumped to 31.5% in Feb-2023, compared to 12.7% in Mar-2022, on the back of a supply shortage for key commodities, as well as floods that hampered the domestic

[1] 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.
[2] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1year 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.

supply of raw materials. As a result, the country is in a dire need of an effective bailout from the IMF[3], amongst financing from other creditors, to replenish its foreign exchange reserves. In a bid to secure funding, the country has dropped its exchange rate cap against the USD, which has spurred domestic inflation and has seen the country's central bank, the State bank of Pakistan (SBP), increase its policy rate by 300bps in Feb-2023 to 20%.

The resultant impact on the corporates domiciled in Pakistan is profound. With borrowing costs soaring and access to favorable credit terms being hindered, Pakistani companies are likely to see heightened refinancing and debt servicing stress in the short term, especially for their forex-denominated borrowings as the PKR depreciates in the absence of an exchange rate cap (See Figure 2b)[4]. The country's banking system is especially exposed to the rise in sovereign risk, partially due to its lending and investing activity in Pakistan's government securities. As of the provisional Jan-2023 figures provided by the SBP, scheduled Pakistani banks provide close to 75.7% of all domestic credit to the government. With Pakistan's sovereign credit risk at distressed levels[5], the risk of heightened non-performing and distressed assets leading to increased losses may hinder domestic banks' willingness to extend credit to the private sector at favorable terms. Pakistani companies' borrowing cost from domestic banks has already soared from 11.5% in Jan-2022 to 17.68% in Jan-2023. Thus, moving forward in such a continued sovereign distress environment, access to relatively cheap domestic loans from the banking sector remains unlikely, sustaining Pakistani companies' high financing and servicing cost, and vis-à-vis, further increasing their credit risk in the short term, as suggested by the rising term structure of their Forward PD in figure 1b.

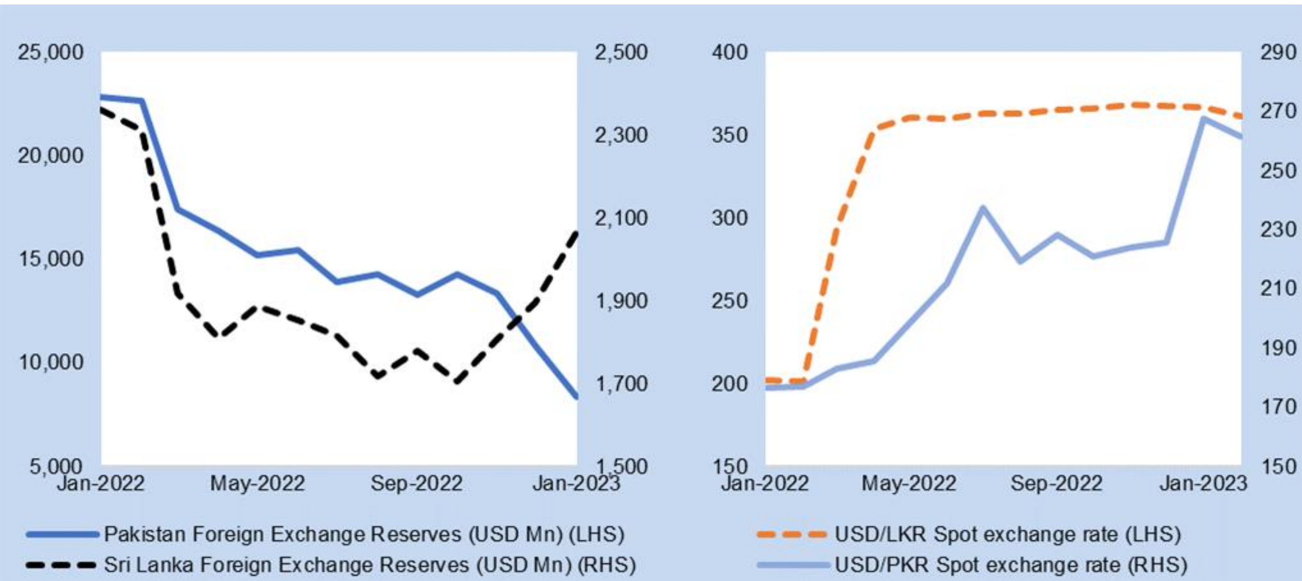

Figure 2a (LHS): Foreign exchange reserves of Pakistan and Sri Lanka Figure 2b (RHS): USD/LKR and USD/PKR spot exchange rates. *Source: Trading Economics, CEIC Data, Bloomberg*

Similarities can be drawn between the sovereign debt crisis faced by Pakistan and Sri Lanka. Though the latter has already defaulted on its sovereign debt in May-2022, prior to the default, Sri Lanka was facing rampant inflation, high-interest rates, supply shortages of key commodities etc, similar to the situation currently faced by Pakistan.[6] However, the Agg PD of Sri Lankan corporates has since decreased as seen in Figure 1a. This has been due in part to an improvement in financing access as market sentiment towards the country's stock and bond market improves. The Sri Lankan government is also close to an IMF bailout that would see its foreign reserve stock increase after its biggest creditor, China, provided assurances to support the country's debt restructuring. Though it seems that Sri Lanka's sovereign debt crisis is receding, corporates domiciled in the country will still face heightened borrowing costs and a free-floating currency, which may be a positive in the long term, but is likely going to make Sri Lankan companies' servicing of forex denominated debt more expensive in the short-term, worsening their credit outlook as shown in Figure 1b. Sri Lankan companies are also likely to continue facing pressure on earnings, especially operating in an inflationary environment where access to cheap raw materials and imported fuel for agriculture and manufacturing needs are limited, while tourism remains muted.

[3] In order to get another bailout by the IMF, Pakistan's government primarily needs to strengthen its fiscal position by raising taxes, loosening the grip on their domestic currencies in order to improve their current account position, and to stop subsidising energy.
[4] According to Bloomberg, close to 93.8% of all outstanding debt is denominated in non-PKR loans and securities for our sample
[5] Pakistan's USD-denominated senior 1-year CDS is currently at 3864.96bps.
[6] The impact was also felt in Sri Lanka's banking industry, with the NUS-CRI Agg PD for Sri Lankan banks increasing drastically at the beginning of last year, prior to the government's default.

As such, the trajectory of how credit risk evolves for Pakistan-domiciled companies may be signaled by Sri Lanka's Agg PD and Forward PD. In the case that Pakistan does end up defaulting on its sovereign debt, which is likely given that the country currently only has foreign reserves that will last a month in the absence of additional financing, a potential restructuring of its sovereign debt might aid the country limit inflationary pressures that are arising due to supply shortages. Concurrently, allowing for a free-floating exchange rate will improve its current account position and improve market participation by international investors in both its corporate bonds and stocks. However, structural issues such as heightened borrowing costs and reduced access to credit may prove to be sticky, thus contributing to a sustained increase in the Forward PD over the next twelve months as shown in Figure 1b.

Credit News

Blackstone defaults on Nordic CMBS as property values wobble

Mar 03. Blackstone, who bought Finnish landlord Sponda in 2018, has not managed to meet EUR 531mn CMBS (issued by a special purpose entity) payment backed by a portfolio of Finnish offices and stores due to declining property values in Europe as a result of rising interest rates. Blackstone has requested an extension from holders of the securitized notes to dispose of assets and repay the debt, but bondholders have voted against a further extension. The gaps between the proposed and offered prices of housing are widening, leading to fewer completed deals and increasing pressure on owners with maturing loans. According to a Scope Ratings report, around a third of commercial-mortgage-backed securities loans set to mature in 2023 and 2024 are at high risk for refinancing. (Bloomberg)

Adani gains support as U.S.-based GQG takes USD 1.87bn stake

Mar 03. The Adani Group raised funds by selling USD 1.87bn of shares in four of its companies to GQG Partners, employees Retirement System of Texas, and the New York State Common Retirement Fund. It said GQG had invested USD 660mn in Adani Enterprises, USD 640mn in Adani Ports and Special Economic Zone, USD 340mn in Adani Green Energy, and USD 230mn in Adani Transmission. Adani Group's top executives have held meetings with investors in Hong Kong and Singapore after TotalEnergies paused a proposed investment due to allegations against Adani of market manipulation and non-transparent disclosure. (Nikkei)

China's struggling bus operators highlight local fiscal woes

Feb 28. China's public transit companies rely heavily on government funding to provide subsidized rides to the public, but with COVID-19 outbreaks and containment measures depleting local governments' resources, operators are struggling to find alternative funding sources to fill the gap in their budgets. As a result, Shangqiu Public Transportation, the largest bus operator in central China's Shangqiu city, announced that it would suspend its inner-city bus routes from March 1 due to mounting losses from the pandemic and reduced subsidies. The company was unable to afford salaries, social insurance contributions, electricity bills, and vehicle insurance. Nevertheless, the government intervened, and the company withdrew its decision. (Nikkei)

Over USD 1tn of risky US loans still shackled to Libor as deadline looms

Feb 28. About four months before Libor expires, more than a trillion dollars of risky US corporate loans are still linked to it, with borrowers and investors arguing over the small print. Only 25% of the USD 1.4tn US junk loan market has migrated to the Secured Overnight Financing Rate (Sofr), Libor's substitute. The rest is locked in a struggle over future interest rates between the heavily indebted corporations who issued the Libor-linked debt and the investors who purchased it. As the Federal Reserve increased interest rates from nearly zero to over 4% last year, the floating interest rates on these loans have skyrocketed. Thus, issuers need to negotiate well to keep their funding costs in check. (FT)

Japanese investors turn net sellers of overseas bonds on U.S. rate worries

Mar 03. For the first time since Jan 27, Japanese investors sold a net JPY 332.6bn worth of foreign bonds last week. The benchmark 10-year Treasury note rate increased by 38.5 basis points last week, the most since four weeks prior. Additionally, Japanese investors sold overseas stocks worth JPY 440.4 bn, continuing a five-week streak of net selling. While purchasing JPY 225.2bn worth of Japanese bonds, foreign investors sold JPY 226.36bn worth of cash equity. (Reuters)

Adani says it has USD 3bn credit line backed by sovereign wealth fund (FT)

American Airlines goes all-In on a USD 15bn debt-cutting plan (Bloomberg)

Eurozone bond yields hit new multi-year highs (BT)

Regulatory Updates

China debt blowout rings alarm bells as leadership meets

Feb 28. Next week, when China's leaders meet in Beijing for the annual parliament, they will discuss the growing debt of the provinces, where 17 provinces are currently funding constraints. Amongst them, with debt roughly three times its income, the provincial-level city of Tianjin faces the greatest threat. The financial crisis has numerous effects on the economy, including driving some consumers to cut back on spending and compelling the federal government to increase spending. To keep the burden of repayment on the provinces under control, the People's Bank of China is expected to maintain low interest rates. As of the end of the previous year, total outstanding local government debt was north of CNY 35tn. (Bloomberg)

BOJ policymaker calls for vigilance on costs of ultra-easy policy

Mar 03. The Bank of Japan (BOJ) must be prepared to mitigate the negative impacts of extended monetary easing. Board member Hajime Takata stated that while the advantages of ultra-loose policy have outweighed the drawbacks, the BOJ must be wary of the pressure on financial institutions' profitability and the bond market. The BOJ widened the 10-year yield target range in December, allowing the yield to increase to 0.5%. (Reuters)

China's central bank signals supportive tone for struggling property sector (FT)

Brussels clamps down on 'greenwashing' in bond market (FT)

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