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High liquidity moderates short-term credit risk of LatAm domiciled corporates but long-term risk remains high

by Shuai Shuai

- **NUS-CRI Forward PD demonstrates heightened credit risk in the long run due to expectations of a persistently weak operating environment and large onset of debt from 2020**
- **Post pandemic, the NUS-CRI Agg PD witnessed a divergence in the representative credit risk of Brazil and Mexico domiciled corporates**

The COVID-19 outbreak has dealt a major blow to the Latin America (LatAm) economies, with the region recording one of the highest infection rates and death tolls. The prolonged lockdowns and accompanying rescue plans have severely damaged public finances across the board. Although the number of cases in LatAm had begun to decline in the late Sep of 2020, it remains one of the most severely affected regions in the world. Major countries like Brazil and Mexico had the largest increases in total debt and, correspondingly, leverage. With the NUS-CRI Agg 1-year PD (Agg PD), as seen in Figure 1a, tapering down; it is evident that the measures taken by governments and central banks successfully mitigated high levels of credit risk to some extent during the depths of the initial shock. However, the NUS-CRI Agg Forward 1-year PD (Forward PD[1]) in Figure 1b suggests a deteriorating outlook in the long run due to the fragility of the underlying economic system that contributes to weak operating environment for the region's corporates.

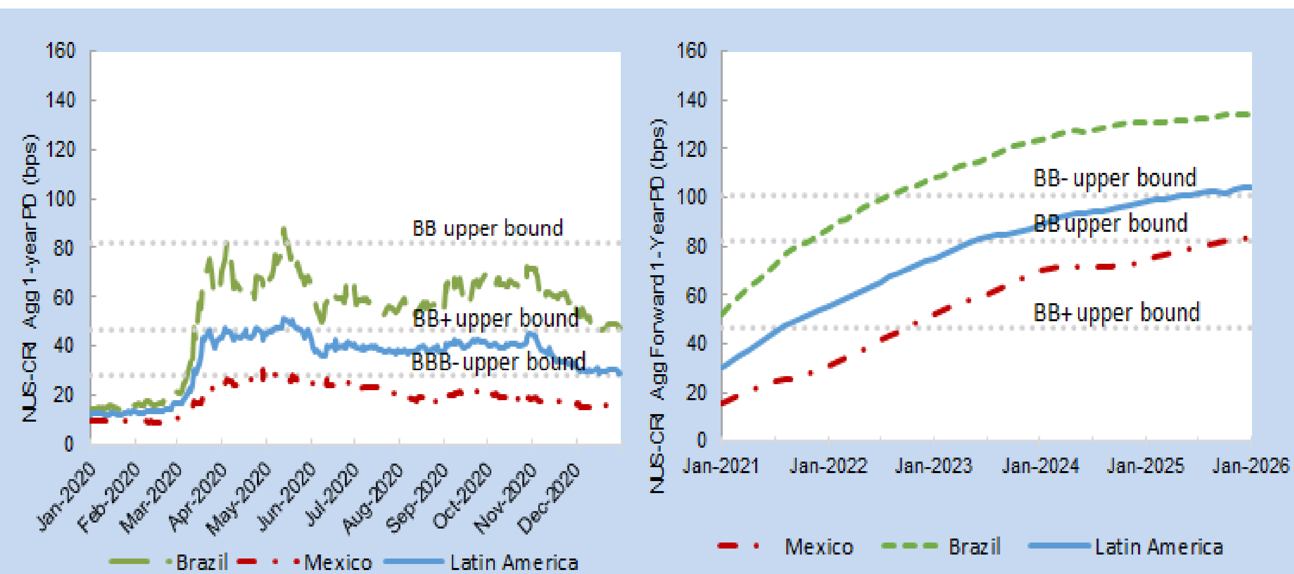

Figure 1a (LHS): NUS-CRI Agg 1-Year PD of Latin America, Brazil and Mexico domiciled corporates. Figure 1b (RHS): NUS-CRI Agg Forward 1-Year PD of Latin America, Brazil and Mexico domiciled corporates based on data feed as of Jan 2021 with reference to the PDiR2.0[2] bounds. *Source: NUS-CRI*

[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 1 year plus 6 months, 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 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.

As the COVID-19 pandemic spreads throughout LatAm, the developing economies have inevitably slipped into recessions. In order to support the financial systems and maintain access to credit, the region's financial stakeholders have implemented accommodative monetary and regulatory interventions. Non-exhaustively, these measures include loosening loan classifications, lowering provision requirements, as well as reducing required capital ratios. In doing so, the bandwidth of institutional lenders has widened to revitalise consumption and businesses. Moreover, governments and special trusts have provided credit guarantees for small- to medium-size enterprises. This goes on to help these firms to attain lower cost of financing. For the larger corporates, a series of financial relief programs were launched to ease restrictions on corporate borrowing.

The pandemic–induced lockdowns drove numerous Latin America companies to defaults in the period from early May to June 2020. Nevertheless, given the low yields in the developed markets, such as the US and Europe, the relatively high yields in LatAm remain attractive for return-hungry investors. In countries like Mexico, small and riskier companies could raise finances from the capital market for the first time in the current environment. With rising demand and issuances, the yield gap between Latin America corporate bonds and US treasury bonds as proxied by the ICE BofA Latin America Emerging Markets Corporate Plus Index Option-Adjusted Spread has fallen by nearly 60% - decreasing to about 370 basis points by mid-December. Nevertheless, the spread between Latin America and US treasury bonds remains relatively large enough to reward investors for accepting higher risks.

The demand for emerging markets' debt and the highly liquid environment drafted by central banks partially account for the downward trend by the Agg PD in late 2020. However, companies have taken advantage of cheap credit by refinancing amidst the weak operating environment. Rising debt levels have resulted in higher aggregate leverage levels. The average Debt/EBITDA ratio of Latin America corporates has risen from 5.57 in 2019 to 6.49 in 2020. The increasingly leveraged profile of Latin American corporates could result in persistently elevated risk over the next few years. The dampened credit outlook is justified as we consider the structural issues embedded in the general economy. Investments in Latin America have a disproportionately lower effect on total GDP when compared to other regions globally. In addition, productivity growth has averaged only 0.5% in the past 10 years - a level that is significantly lower than the aggregate 4.5% of the overall emerging markets group.

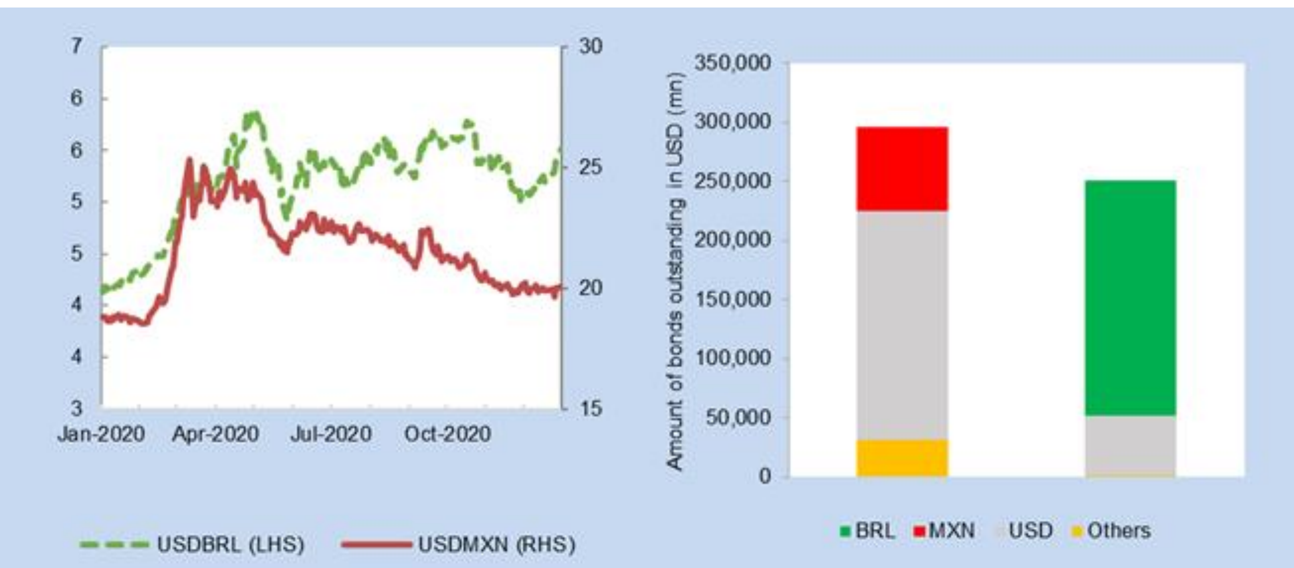

Figure 2a (LHS): Currency pairs of US Dollar (USD) against Brazilian Real (BRL) and US Dollar (USD) and Mexican Peso (MXN) over 2020. Figure 2b (RHS): Total Outstanding Debt for listed corporates in Mexico (left) and Brazil (right), separated by currency denomination. *Source: Bloomberg*

With attention to two of the biggest economies within the region, Mexico and Brazil, the Agg PD in Figure 1b demonstrates a substantial divergence upon the outbreak of COVID-19. Moving forward, the credit outlook for Brazil is substantially elevated relative to that of Mexico. This can be partially accounted for by the debt composition of the two countries, as shown in Figure 2b. The outstanding debt issuance of Mexico is denominated largely in USD. The US dollar has depreciated against the Peso (MXN) since Apr 2020 as seen from Figure 2a. This eases the strain for corporate issuers as they are now able to service their debt with the relatively stronger MXN. However, Brazil domiciled corporates are unable to benefit from the same phenomenon, as Brazil debt is issued mainly in Real (BRL), which is the same as their reporting currency.

While the currency movement momentarily eases the aggregate credit risk faced by Mexican corporates. These firms are not unabated from the prevailing risks faced by the region. Domestic companies are likely to see long periods of weak operating environments, as further lockdowns and weak spending power caused by high unemployment will suppress economic activity and demand. This is likely to increase elevated credit risks in the long term, as they load up on excess debt while suffering from a poor revenue outlook. Poor earnings and larger debt service requirements will put a strain on the credit quality of corporates in the region, and a weak growth outlook does not give any respite to their long-term performance post-pandemic.

Credit News

Australian gold miners rush for funding amid rising metal market

Jan 8. Australian gold miners are set to benefit in 2021 from rising gold prices. Gold hit AUD 2,067 per ounce in August as investors stuck to its safe-haven status during the pandemic. Firms have rushed to capital markets to seek funds to restart mines and develop new projects. With these new higher margins, investors are willing to finance projects earlier in the production stages and to small-medium sized companies. Companies with overseas assets have also taken on financing opportunities through the ASX. Gold companies raised AUD 761mn in Sep 2020, followed by AUD 812mn in Oct and Nov. Gold production accounted for 10% of the world production, second only to China. Strong gold prices are also driving M&A deals in the industry, providing positive prospects for future production capabilities. (Nikkei Asia)

Foreign investors shun corporate bonds in frenzy for Chinese debt

Jan 8. In 2020, foreign investments were channeled to the Chinese debt market due to their relatively high yields. However, in light of the recent defaults, many withdrew their holdings. On close, the year saw a 28% decline in corporate bonds traded by foreign institutions. Economists cited that the Chinese corporate debt crunch and rising bank loans will be the pitfalls to note moving forward. Nevertheless, overall financial risk will remain subdued given that a large proportion of debt is domestically financed amidst the liquid market condition. (Nikkei Asia)

IMF says China needs a way to wind down troubled banks

Jan 8. In order for China's economic growth to be sustained in the medium term, there is an imperative for lenders with bad debt to be liquidated. Despite the pandemic, the Chinese government and central bank were applauded for their swift and effective responses. Growth in the previous quarters was driven by public spending. However, the drive is unbalanced – private spending must catch up. The temporary measures to increase liquidity and loan forbearance need to be replaced with supervisory frameworks. (Nikkei Asia)

US credit markets off to a record start in 2021

Jan 6. Almost USD 50bn of new debt has been sold to investors as companies look to refinance at low costs and fund takeovers in the first two days of the year. Studio company was the first to issue USD 750mn 8-year bond to refinance debt coming due in 2024; followed by Broadcom, which raised USD 10bn across 5 maturities to help pay-off coming dues. This follows a record-breaking borrowing binge in 2020, where companies in the US raised USD 2.5tn. Overall issuance is expected to decline this year, though there are opportunities for companies to issue more debt given the low cost of financing. The average yield across IG bonds ended in 2020 at an all-time low of 1.78%. Lower rated issuers, offering higher yields, have already sold more bonds than in any previous first trading week of the year, as investors are convinced that supportive policy will keep rates down. (FT)

Distressed debt specialist Howard Marks warns on corporate borrowing burden

Jan 5. Companies are facing over-leveraged balance sheets as they hoard cash to weather the pandemic. However, this may prove to be an issue down the line, as they face difficulty in reservicing their debt even after returning to pre-pandemic profits. Global corporate debt issues and syndicated loans increased significantly to USD 5.4tn and USD 3.5tn respectively, leading to debt-heavy capital structures. Over 500 companies were flagged as having high credit risk last month, while 9 percent of junk-rated US bonds could face default by September. However, investors are still betting on the debt market recovering, leading to a rise in prices as investors continue to look for positive returns in the market. (FT)

EasyJet signs new five-year term loan facility (Reuters)

Alibaba plans to raise up to USD 8bn in dollar bond sale (FT)

Pemex drains reserve of quick fixes as cash crunch looms (FT)

Regulatory Updates

Chinese central bank will prioritize monetary policy stability in 2021

Jan 8. Moving forward, the central bank aims to maintain its existing imperative to keep liquidity available and provide fiscal support. Beyond, they will be focusing on sustainability – giving support to small firms, technology and green development. While there has been a lot of talk on scaling back monetary support, fears of an economic slump and looming defaults are likely to prevent conditions from tightening anytime soon. The pullback in support will be more fiscal in nature as the central government expects the low rates environment to support the economy. (Reuters)

Covid-19 small business loan program PPP to reopen Jan 11

Jan 8. The Paycheck Protection Program will resume on Monday for new entrants, while repeat borrowers would be able to access the service on Wednesday. Over USD 284bn will be provided to SMEs under the USD 900bn relief bill, but businesses will stand to gain less this time around as compared to the USD 525bn that was handed to companies in the middle of 2020. Businesses that were able to take advantage of the program last year will now have to prove that they experienced a fall in year-on-year revenue, while also having a borrowing cap of USD 2mn. SMEs are increasingly dependent on the program, as they can stave off unemployment by up to 25% with the forgivable loans provided. (WSJ)

Indonesia sets new rules on payments system (Business Times)

Germany to extend insolvency moratorium beyond Jan (Reuters)

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