Credit Research Initiative
Risk Management Institute, National University of Singapore
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Advancing Risk Management for Singapore and Beyond
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Weekly Credit Brief
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UK export oriented sectors to EU see increased credit risk due to uncertainty of Brexit deal

By Zhou Ye

European economies ended 2018 weaker than its start as two of the continent's biggest economies, Germany and Italy, are on the brink of recession. With the countdown to Brexit and no deal in sight, the situation may even worsen. Tracked by NUS-CRI 1-year Aggregate PD (Agg PD), the hardest hit in credit outlook is the United Kingdom (UK). The NUS-CRI 1-year Agg PD witnessed a two-year high for the companies domiciled in the European Union countries (EU) at the end of last year, since the 2016 UK European Union membership referendum. Looking more closely, the UK sees an increase in credit risk as compared to the EU. As Brexit moves closer, the gap of the 1-year Agg PD between the UK and the EU becomes larger.

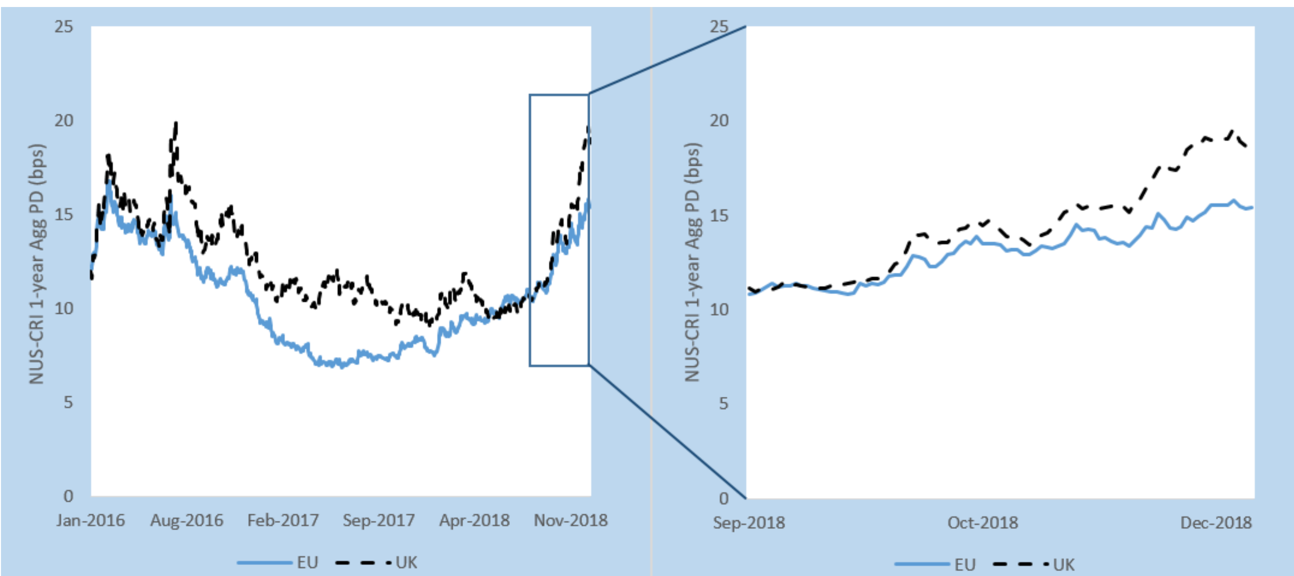

Figure 1a & 1b: NUS-CRI 1-year Aggregate PD for the European Union, the United Kingdom. *Source: NUS-CRI*

On the whole, compared with the EU, the UK economy may suffer even more from an immediate and unpredictable jolt from a no-deal Brexit. The EU and the UK has long been integrated through the custom union, which enables frictionless and tariff-free trade between its member states. A no-deal Brexit can easily evaporate the benefit from the integration, as UK becomes a "third country" that will be treated as an outside economy. Tariffs and border custom checks would be in place and may slow down supply chain and shipments. UK relies heavily on the EU markets, which contribute 44.5% of its total exports, and 53.1% of its total imports.

Among the total exports, road vehicles are one of the UK's largest export to the EU, 11% of all UK goods exports to the EU and 45% of all UK exports of road vehicles are to the EU. The countdown to Brexit without a deal has caused uncertainty in the industry. At the end of last year, the UK automotive industry produced lower EBITDA growth and higher debt to EBITDA ratio than that in the EU. The machinery industry is also one of the largest UK's export to the EU which contributed 11.6% of all UK exports. The NUS-CRI 1-year Agg PD witnessed a higher credit risk for UK than the EU during the second half of last year for these two industries.

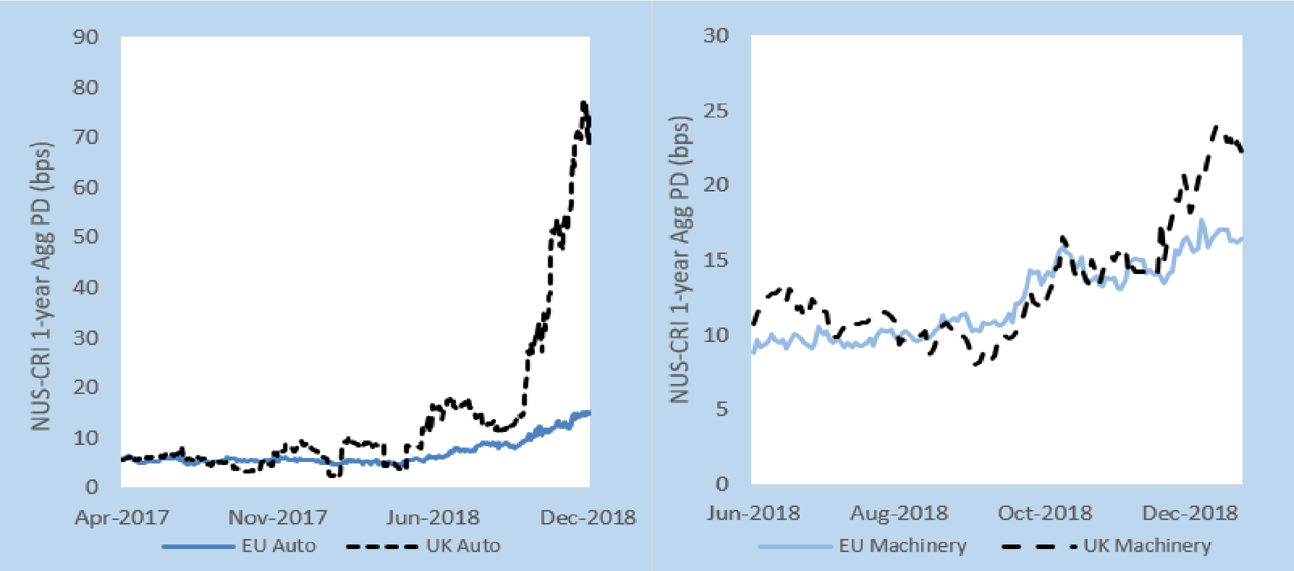

Figure 2a & 2b: NUS-CRI 1-year Aggregate PD for Machinery and Automotive in the European Union and the United Kingdom. *Source: NUS-CRI.*

Apart from Brexit, Europe is also facing a slowdown in its economy. On January 4, IHS Markit published that in December, the Euro zone manufacturing purchasing manager's index (PMI), fell into a four-year low to 51.4 from 51.8 in the previous month (a PMI reading under 50 represents a contraction). Eurozone industrial production also fell by 3.3% YoY in November 2018. A hard Brexit may further worsen the economic climate of European economies, especially multinational manufacturers, as significant barriers and tariffs on goods and restrictions on trade in service may arise.

For instance, a no-deal Brexit will have a huge impact for the UK aerospace industry which exports 50% of the industry production to the EU. Though the EU is preparing new regulations to mitigate the impact of hard Brexit, the planned regulations does not apply to the aerospace industry. The European Aviation Safety Agency (EASA) has regulations that stipulate that some parts of an EU-made aircraft would need to be sourced from its European members. A no-deal Brexit will forbid British-made aircraft parts to be installed in European jets as EASA would no longer have supervisory authority over the UK. A similar situation can also be expected for automakers. The production and supply chains of these manufacturers may be delayed due to regulations and restrictions on trade. The NUS-CRI 1-year PD increases for both the EU and the UK aerospace industry, indicating a worse credit outlook at the end of last year. Comparing the industry's financials of the two regions as at the end of last year, the EU aerospace industry has a lower profit margin, lower EBITDA growth and higher debt to EBITDA ratio than its peers in the UK.

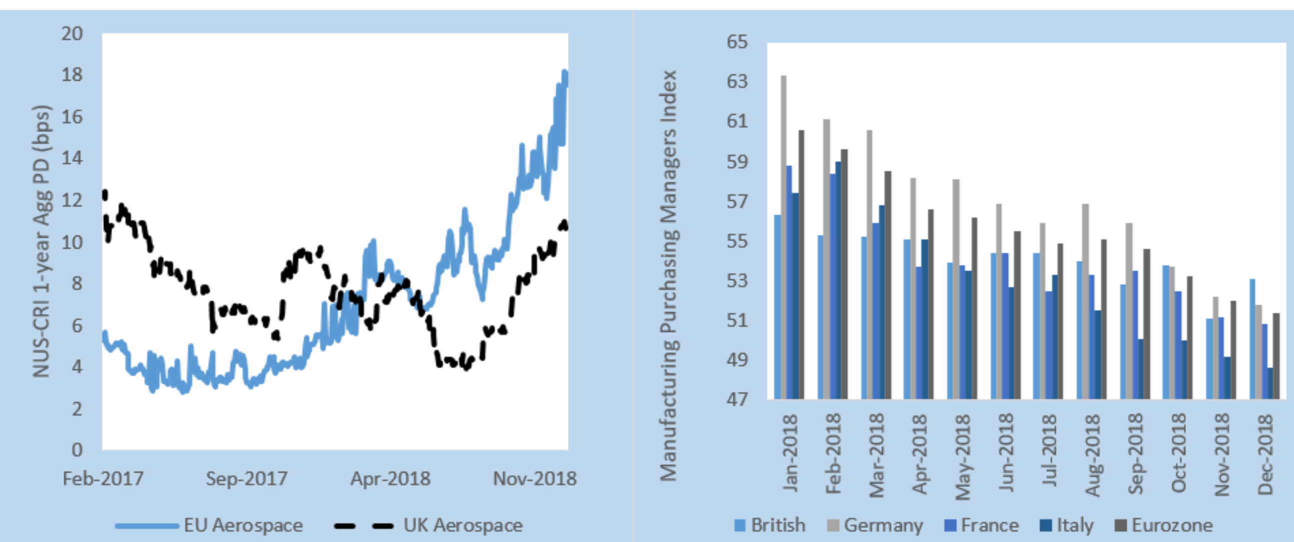

Figure 3a & 3b: NUS-CRI 1-year Aggregate PD for Aerospace industry in the European Union and the United Kingdom and Euro Area Manufacturing PMI. *Source: NUS-CRI, Trading Economics*

	Profit Margin (%)	EBITDA Growth YoY (%)	Net Debt/EBITDA (X)	Current Ratio (X)
EU Aerospace	2.02	9.29	1.25	1.24
UK Aerospace	5.05	21.07	0.93	1.51
EU Automotive	3.16	7.51	1.22	1.37
UK Automotive	3.09	0.80	1.36	1.19

Table 1: Financial ratios for automotive industry and aerospace industry in the European Union and the United Kingdom. *Source: Bloomberg*

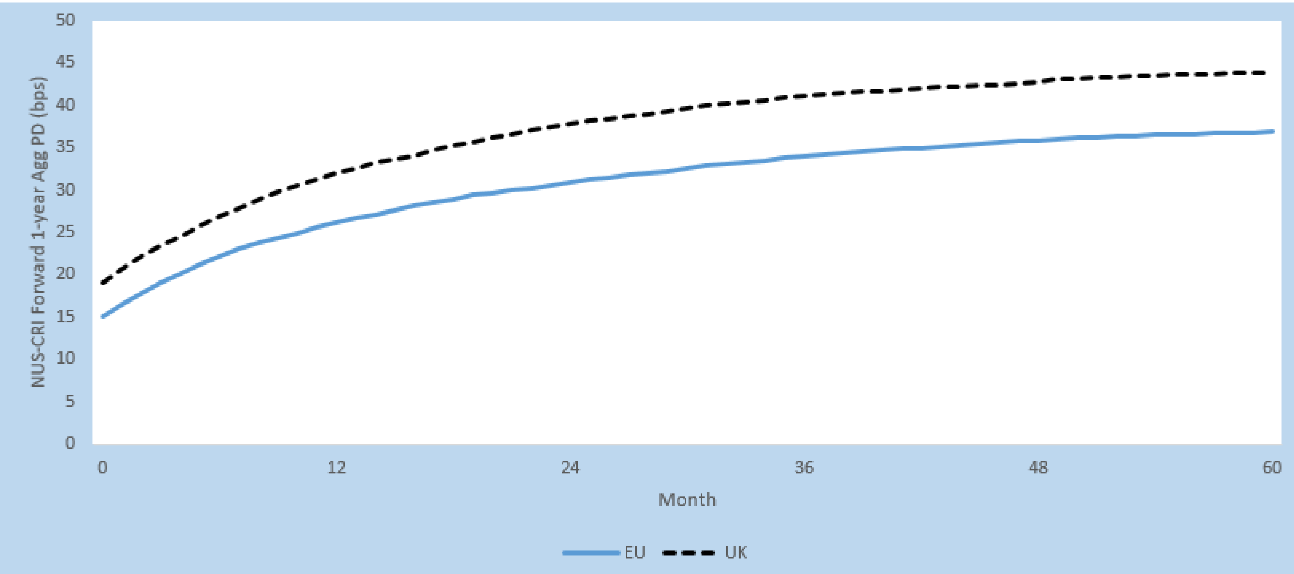

Figure 4: NUS-CRI Forward 1-year Aggregate PD for the European Union and the United Kingdom at 01 Jan 2019. *Source: NUS-CRI*

For the region's future credit outlook, Eurozone growth forecast for this year is experiencing a fresh low, reflecting how political uncertainty raises gloom on economic activity. Figure 4 illustrates the NUS-CRI forward PD, which works 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 month onwards to 1 year plus 6 months, conditional on the firm surviving the next 6 months. The figure below shows a continuous increasing probability of default for the UK and the EU, which is especially steeper in the next one year, indicating a heightened credit risk associated with the uncertainties in the near term, in particular the Brexit negotiations. The UK also has a higher forward 1-year Agg PD than the EU over the time horizon, and the gap becomes larger, indicating a long-term economic uncertainty and higher credit risk for the UK.

Credit News

European borrowers find breaking up with Libor is hard to do

Jan 25. Borrowers have yet to switch away from the familiar London interback offered rate (Libor) and its euro equivalent (Euribor) as they anticipate suitable new reference rates that offer a range of maturities. This year, 10 issuers have raised bonds based on the Sterling Overnight Index Average (Sonia) but none have done so in the European loan market. Using Sonia will remain problematic until risk-free term rates emerge that mimic the three-month or six-month tenors typically used by borrowers and lenders. However, by waiting for suitable term rates to emerge and raising new loans based on Libor or Euribor, banks are increasing the volume of outstanding debt that would need to transition to new reference rates. The UK Financial Conduct Authority plans to scrap the benchmark by 2021. (Bloomberg)

Banks presence shrinks in the US corporate bond market

Jan 25. US corporate bonds sales from financial companies have sold around USD 50bn of bonds so far this year, down more than 40% compared to the same period a year ago. The reason for the drop is that banks have largely sold sufficient debt to meet the requirements of a Federal Reserve regulation and tax cut have lifted their cash flow which reduces their borrowing needs. Some analysts pointed out that the declining sales of new bonds could also be one of the most significant short-term tailwinds for a market that faces long-term risks as about half of outstanding investment graded debt is in the tier just above junk. Investment grade corporate bond sales have also fallen by 15% from the same period last year and some strategists have issued buy calls on corporate bonds as many money managers view these debt as relatively cheap. (Bloomberg)

China companies suspected of buying own bonds to spur demand

Jan 23. Challenged by policymakers' deleveraging push in the financial system, Chinese companies began using structured issuance as a creative way to boost market demand for the issuer's own bonds. Structured issuance is a tactic which bond issuers indirectly buy their own bond offerings to inflate issuance sizes, creating the image of greater access to capital, and leading to lower coupons in subsequent sales. The main users of structured issuance are lower rated private companies and local government financing vehicles. One popoular method is that the borrower put up the money for the subordinated tranche, which is the first to absorb losses, of the asset-management vehicle that buys the bonds. However, this will expose buyers of the senior tranche to greater risk in case of default. (Business Times)

Capital raising by US oil companies falls sharply

Jan 23. Following the decline in crude prices since last October, capital raising by US oil exploration and production companies has fallen sharply, indicating cutbacks in capital spending and a continuing slowdown in activity. Potential borrowers were put off by the increasing spreads over US Treasury bonds which climbed from 3.9 to 7.5 percentage points at their peak before settling back to 5.9 percentage points this year. Consequently, the lack of new capital and tight cash flows compelled oil production companies to hold back their plans for drilling and completing new wells. Meanwhile, big international oil groups that have the greatest access to capital due to investors' preference for larger companies are able to get their development financed more efficiently. (FT)

China bad debt disposals hit levels not seen for 20 years

Jan 23. Disposals of bad debt in China have reached a high of CNY 1.75tn over the past 20 years as the banking sector struggles with an onslaught of poor-quality loans in 2018. Prices of these debt have also hit a decade low as more debt from regional banks with poor quality loans are entering into the market. The slowing economy will also put more pressure on repayment of loans in the coming years. A number of provincial asset management companies (AMCs) have also been set up in addition to the four centrally controlled AMCs set up in 1999. A number of private investors and foreign investors have also entered into the market. Despite the rise in disposals of bad loans, uncertainty still remains if the government will be forced to take bigger measures. (FT)

China offshore syndicated loan issuers expected to pay higher costs (Bloomberg)

Italian lenders increasingly cautious, quarterly ECB survey shows (FT)

Fitch warns emerging markets face more downgrades this year (Bloomberg)

Regulatory Updates

Three years later, India's bankruptcy reform languishes in courts

Jan 27. In 2016, India introduced new bankruptcy resolution rules with hopes for state-owned banks to clear up some of their bad loans and create a dynamic market in restructured debt, thus removing an impediment to higher economic growth. However, it appears that such litigation has tied down some big restructuring deals, such as the one involving Essar Steel, and bankers are starting to sell bad debts at fire sale prices rather than wait for the system to improve. Bankers and investors believe that while the bankruptcy code was a step forward, the effectiveness could be enhanced if restrictions on the scope for litigation had been included and timelines are maintained. (Reuters)

China's central bank just moved one step closer to flinging open the floodgates of stimulus

Jan 25. The PBOC unveiled its bill swap mechanism on Thursday evening, the latest effort to increase the financing support for the real economy amid the trade war and a global economic slowdown. The bill swap allows holders to swap commercial bank perpetual debt for central bank bills to be used for borrowing collateral. Immediately after the launch, the China Banking and Insurance Regulatory Commission eased restrictions on insurers looking to invest in perpetual debt. The moves are seen as a Chinese version of quantitative easing but there are concerns on whether banks are willing to on-lend the capital to companies. (SCMP)

S&P Global gets green light to rate domestic bonds in China (FT)

Nigeria plans tougher bank capital rules as bad debts weigh (Bloomberg)

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