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Weekly Credit Brief Jul 05 - Jul 11 2022

Amidst deteriorating supply chain conditions, Uniper's credit profile worsens the most amongst German utilities

by Aditi Kamath

- **NUS-CRI Aggregate (median) Forward 1-year PD suggests that credit health of German utilities is set to deteriorate owing to curtailed gas supply and rising global fuel costs**
- **Uniper faces drastically higher credit risk than the rest of the industry, owing to nearing debt maturities and worsening cash position due to its heavy reliance on Russian gas imports**

Germany stands at the cusp of an energy crisis as the nation initiates the second phase of its 3-stage emergency gas plans following Russia's move to further curtail the supply of gas to its European counterparts. The decline in the supply of natural gas imported from Russia, which makes up nearly half of Germany's gas supply, has pushed up operating costs for Germany-domiciled utility firms companies. As seen in Figure 1a, NUS-CRI Aggregate (median) 1-year PD (Agg PD) of German utilities has deteriorated since sanctions have been placed on Russian exports. Diving into the industry, Uniper, the largest importer of Russian gas, stood out as an outlier with a substantially elevated PD (See Figure 2a). Uniper has also been making the headlines with the latest being that the German government is poised to decide on Uniper's requested bailout soon. Zooming out, the credit health of the German utility industry may continue to worsen as suggested by the NUS-CRI Aggregate (median) Forward 1-year PD (Forward PD[1]). Amidst the backdrop of higher commodity prices alongside the cut in supply from Russia, these corporations are now caught between a rock and a hard place. They are left to either source for costlier inputs from the alternative markets or invest in renewables which require hefty start-up costs and time to roll out.

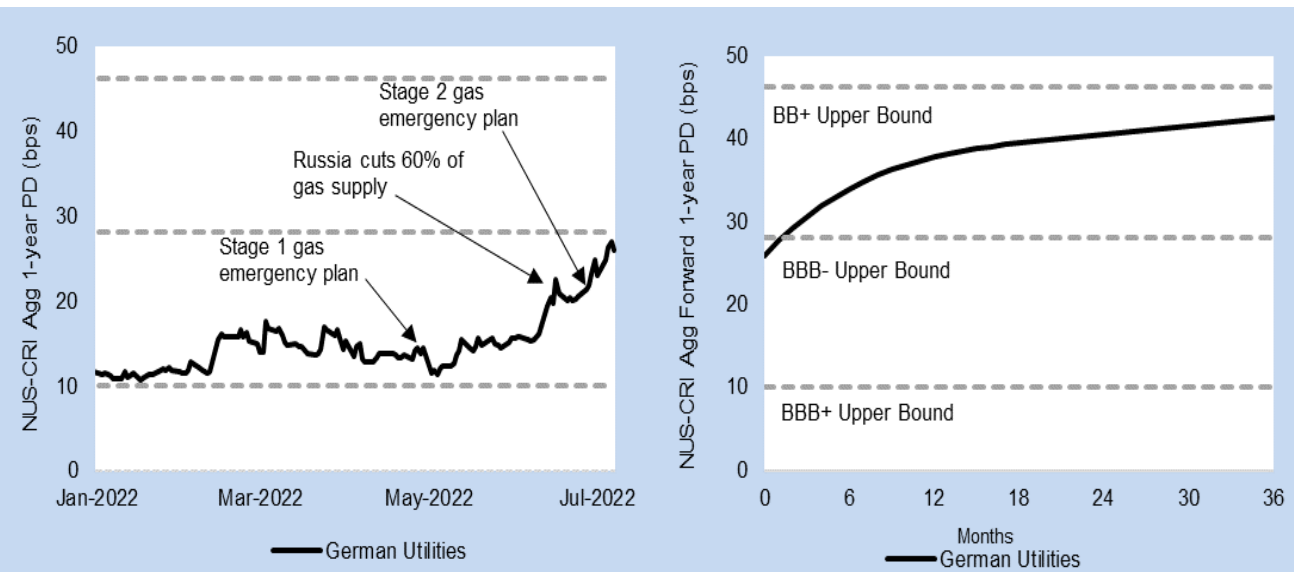

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for German utility firms[2] from Jan-2022 to Jul-2022 with reference to PDiR2.0 bounds[3]. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for German utility firms as of Jul-2022 with reference to PDiR2.0 bounds. *Source: NUS-CRI*

[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 18 months – this is conditional on the firm's survival in the next 6 months.
[2] Sample includes German utility firms which generate power from non-renewable sources.
[3] 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.

Despite the German government's efforts to shore up supply and extend credit, the mitigative measures proved insufficient to quell the ongoing credit risks. Supply conditions continue to worsen as Russia reduced its gas supply to Germany by 60% in Jun-2022. Adding on to the supply constraints, the Nord Stream 1 pipeline is closed for maintenance till 21st July, and Germany expects little to no resumption of gas supply. As a result, gas prices have climbed to a 6-month high, soaring to EUR169 MW/h, nearly double of Jan-2022 levels. Amid the elevated cost of gas, gas-intensive utility firms now face rising input costs and pressure on the already battered margins. Outside of less than successful measures to bring stability to the gas price volatility, the German government has provided EUR 15bn in credit lines to fund the acquisition of gas from alternative sources with the objective of ramping up storage capacities to ensure adequate power supply for the coming winter season. However, given that gas prices are likely to be higher for longer, marginal improvements in funding accessibility through the allotment of such credit lines are likely to be insufficient. The German utilities may be required to rack up additional debt to finance mounting input costs, low outputs and reduced prices. ECB's plans for consecutive interest rate hikes to combat inflation may provide additional headwinds to companies who would require to refinance their debt in the near future.

Bearing the brunt is the German utilities giant, Uniper SE, whose imports from Russia account for over 50% of its gas purchases. The company's PD has been increasing drastically since the beginning of the Russia-Ukraine crisis (See Figure 2a), however, the latest spike in PD highlights the company's worsened credit profile as it faces the burden of servicing upcoming debt maturities. Uniper faces close to EUR 400mn (around 16% of total outstanding debt) coming due over the next 6 months. Without further efforts by the company to refinance, the remainder of the company's debt outstanding (around EUR 2.03bn) is also set to mature in 2023. Over the course of the year, the company substantially increased its leverage since the beginning of the crisis, with its debt to capital ratio increased by more than 20% QoQ to around 76% in Q1-2022.

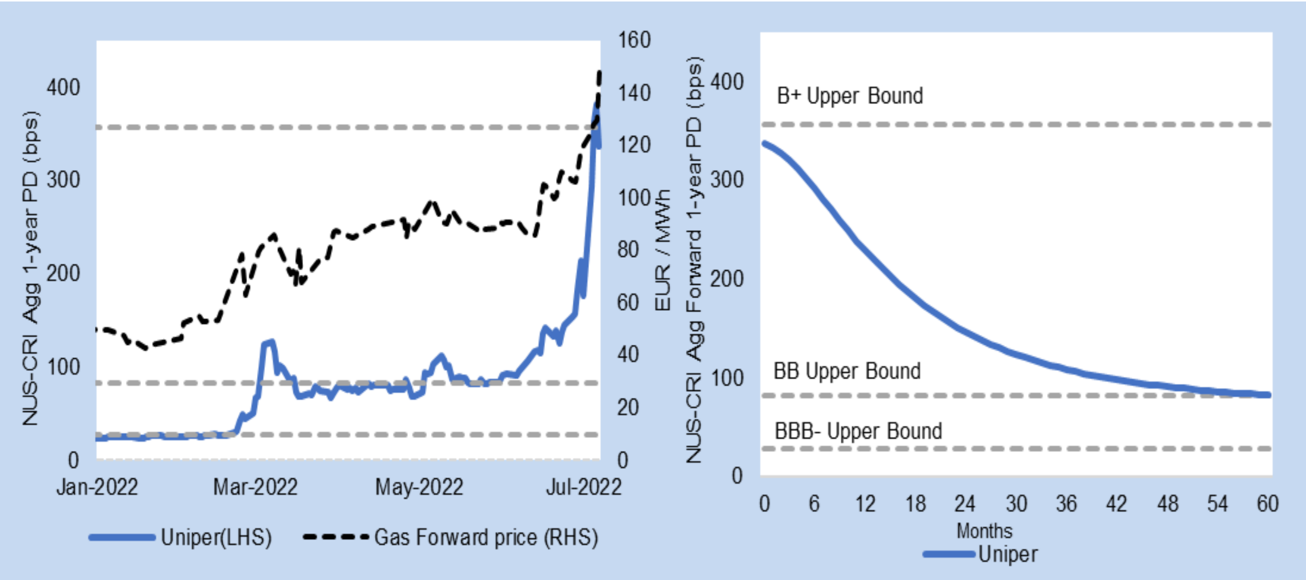

Figure 2a (LHS): NUS-CRI 1-year PD for Uniper from Jan-2022 to Jul-2022 with reference to PDiR2.0 bounds; Germany THE Natural Gas 2023 Forward price. Figure 2b (RHS): NUS-CRI Forward 1-year PD for Uniper as of Jul-2022 with reference to PDiR2.0 bounds. *Source: NUS-CRI, Bloomberg*

Adding pressure on Uniper's debt servicing ability is its depleting cash reserves. Even prior to the crisis, the company has been burning through cash in order to meet collateral obligations on its forward sales[4]. Given that the company burnt through EUR 4.4bn in cash collaterals between Jan and Sep-2021, prior to the upswing in forward prices seen in 2022 (See Figure 2a), the company's cash position is likely to worsen even further in 2022, severely hindering their debt repayment ability. Nonetheless, as Uniper plays a major role in the government's direction of decreasing reliance on Russian fuel, the German government may be inclined to push through with granting its requested cash bailout, amounting to close to EUR 9bn. The effect of the government's support in providing Uniper with a lifeline to avert defaulting on its maturing bonds and loan facilities, and potentially finance short-term operating requirements can be gleaned in the downward-sloping Forward PD (See Figure 2b). As the terminal[5] for receiving liquified natural gas becomes operational approximately by the end of the year, Uniper's supply woes would have been partially addressed, potentially offsetting any further anticipated increases in Russian gas prices.

[4] Uniper makes forward sales by locking in future prices as a guarantee of contract fulfillment, it is required to post a cash collateral which is dependent on the underlying commodity. In 2021, the company experienced outflows of EUR 4.4bn towards cash collaterals as market volatilities drove prices higher.

[5] The terminal is stipulated to provide for approximately 8.5% of Germany's gas demand.

With the impact of the Russia-Ukraine war underlining the German gas utilities' dependence on Russian gas and highlighting its vulnerabilities to supply chain disruptions, the German government has undertaken measures to fortify the industry moving forward. In the short term, the German government aims to bridge operating needs by providing credit lines to ease the adverse effect on margins and debt servicing capacity for the whole industry. Notwithstanding the government support, the fallout of the restriction in Russian supply will likely be continually felt by the industry until the transition to alternative fuel supply is finally complete. On the other hand, should the financial aid requested by Uniper be granted, the company is likely to see its credit profile improving owing to the influx in its cash position, potentially alleviating short term financing needs. Further, as the company has already made active investments towards diversifying its fuel inputs, its benefits may be realized in the form of reduced financial impact from the volatility in gas prices in the long term. Regardless, the industry still faces short term challenges pertaining to the ongoing uncertainty in oil prices as suggested by the Forward PD in Figure 1b.

Credit News

Real estate funding model in danger as ECB's easy money era ends

Jul 11. The end of the ultra-loose monetary policy of the ECB has posed a threat to the European real estate sector's business model which relies heavily on debt to fund growth. Resultantly, an index of the real estate sector's bonds has registered a loss of 17% YTD, making it the worst-performing sector in the region's bond market. With ECB's plans to tighten monetary policy, investors fear that the sector will find it increasingly difficult to refinance its debt load in the coming quarters. The average yields of EUR-denominated real estate bonds have jumped to 4.58% as compared to 0.4%in Aug-2021. (Bloomberg)

China developers face USD 13bn wall of dollar bond payments in second half

Jul 08. Refinancing problems have been hounding Chinese developers amidst low demand for housing caused by the lockdowns, higher borrowing costs fueled by the Fed's interest rate hikes, and current downward pressure in the Chinese economy. These mounting concerns, coupled with the recent default of Shimao Group on its outstanding USD-denominated debt, worries foreign investors, especially as 13% of the sector's outstanding obligations become due before the end of the year. The foreign investors also fear that onshore debtholders might be given preference in the subsequent repayment arrangements, considering the restructuring terms for Evergrande and other previously defaulted developers. (FT)

Evergrande risks first local bond default as delay rejected

Jul 11. The group was denied of their request to extend a bond repayment by local creditors for the first time. This first could lead to a landmark onshore default, encouraging financiers to take a stronger stance against the battered property developers. Industry expert notes potential implications in the pricing of extended real estate bonds. Per article's time of writing, China's high yield dollar junk notes fell 0.5c to 1c on the dollar. (Bloomberg)

Shimao creditors get organized after USD 1bn bond default

Jul 05. After Shimao Group defaulted, bondholders are planning to organize themselves to be able to increase the probability of advocating for their interests during the restructuring process. Such a process would likely benefit foreign bondholders who are fearing that they would be bumped off the prioritization by onshore creditors. Moreover, the investors are also looking out for any form of government support to potentially increase debt recovery. (Bloomberg)

Rates shock puts loonie corporate bond sellers on slower track

Jul 06. Industry experts note that the record of CAD 136bn (USD 104.3bn) corporate bond sales in 2021 will be difficult to reach. This can be attributed to (1) companies facing the highest coupon payments for new debt in 13 years and (2) central banks worldwide battling inflation. M&A announcements related to Canadian companies, which are down by around 49% to CAD 62.8bn YoY according to Bloomberg data, also corroborate the hypothesis. (Bloomberg)

'Doom loop' fears are putting Italian banks to the test (WSJ)

Thai firms may sell record USD 33bn of new bonds on rate concerns (Bloomberg)

Klarna's valuation crashes to under USD 7bn in tough funding round (FT)

Regulatory Updates

China considers USD 220bn stimulus with unprecedented bond sales

Jul 06. With signs pointing that the Chinese economy might be slowing down for the first time since 2020, the Chinese Ministry of Finance is considering special bond issuance in 2H 2022 for infrastructure funding. The proposal is expected to address the fiscal pressures faced by local governments due to the decline in revenues following the housing market slump and the tax reliefs granted to support businesses, and increasing costs for COVID-19 testing and additional controls. As infrastructure is seen as the key driver of China's GDP growth, the boost in spending is expected to increase GDP to about 5% in 2H 2022, albeit below the full-year goal. (Bloomberg)

BoE says overhaul of insurance rules cannot be a 'free lunch' for sector

Jul 06. BoE's Prudential Regulation Authority (PRA) has been dealing with the negative fallout from the UK government and industry participants regarding the changes to the solvency two regimes. The policy dictates the amount of capital the insurers will need to hold and what asset classes they can invest in. Both the government and industry find the regulations to be stringent, limiting the risk insurers can take on. The PRA has since responded that the regulatory overhaul is meant to protect pensioners from unnecessary credit risk, and changes in regulatory policies cannot act as a "free lunch" for the industry. (FT)

India's central bank takes steps to stem Rupee's slide (WSJ)

Switzerland surprised markets with a rate hike. But Japan could cause a much more violent reaction (CNBC)

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Contributing Editors: Raghav Mathur, NUS-CRI Market Monitoring Team, Wang Anyi