South African companies' credit risk jumps as Covid-19 amplifies the country's economic slowdown

by Mehul Sukkawala

South Africa, the 2nd largest economy on the African continent and one of the 'BRICS' members, has been struggling for the last few years with an average economic growth of less than 1% over the last 5 years and its GDP per capita registering negative growth. Now, Covid-19 is causing a sharp slowdown in the country's economy, with the government expecting the economy to contract by about 7% this year. This has put further pressure on the operating and financial performance of companies in the country and thereby increasing their credit risk. This is similar to what we see with the other BRICS member Brazil. However, in South Africa, we have possibly passed the worst with the government now gradually opening the economy as compared to Brazil which is also facing political challenges. Nevertheless, the risk remains elevated if either the Covid-19 situation significantly worsens in South Africa in the near term or the government is not able to improve the operating environment for companies in the medium term.

The credit profile of publicly-listed South African firms started to gradually weaken in February of this year and the pace accelerated in March as Covid-19 started spreading globally. This is evident from Figure 1b which shows the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) starting from July 2019. The situation remained grim for South African companies as the government implemented a stringent country-wide lockdown for 5 weeks from March 27 to April 30. This meant that the Agg PD of South African listed companies, which was on the cusp of investment grade and speculative grade before the Covid-19 outbreak, moved distinctly into speculative grade to 'BB-' levels as per the NUS-CRI Probability of Default Implied Ratings (PDiR2.0[1]). The credit risk for these companies only started to improve in the latter half of May as the government started opening the local economy in phases, partly from May 1 and significantly more from June 1. Despite the improvement, however, the median credit profile still remains well into the speculative grade category.

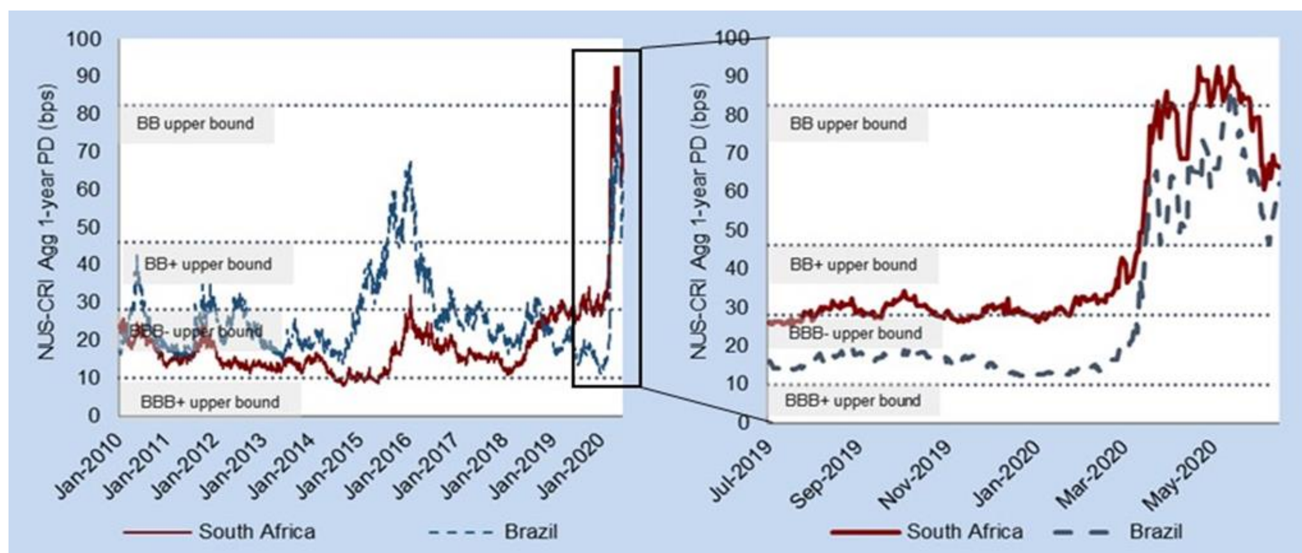

Figure 1a (LHS): NUS-CRI Aggregate 1-year PD for listed companies in South Africa and Brazil from January 2010 bounded by PDiR2.0; Figure 1b (RHS): NUS-CRI Aggregate 1-year PD for listed companies in South Africa and Brazil from July 2019 bounded by PDiR2.0. *Source: NUS-CRI.*

[1] 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.

The credit risk for listed companies in South Africa displayed similar trends to its Brazil counterparts over the last one year. The only difference is that South African companies have generally shown a slightly higher risk compared to companies in Brazil as we can see in Figure 1b. The gap between the two Agg PD has mostly remained at less than 20bps during this period. However, this was not always the case. As we can see from Figure 1a, prior to late 2018, South African companies were consistently less risky than their Brazilian counterparts. In fact, during the last 10 years, the risk of South African companies has generally remained steadier and at lower levels compared to companies in Brazil which have been more volatile and also went through significant stress during 2015 and 2016.

Within South Africa, if we look at the five sectors with the largest number of listed companies, industrial companies have been hit the hardest in terms of an increase in Agg PD of about 50 bps. And, to begin with, it was the riskiest industry as can be seen from the range of Agg PD starting Oct 2019 for the sector in Figure 2a. This is because the sector, which accounts for 13% of the GDP, has been facing adverse impacts from power shortages that result in blackouts, low business confidence and unemployment rates of almost 30%. The challenges for the sector can also be seen from IHS Markit's South Africa Purchasing Managers' Index which was below 50 (the level that separates contraction from expansion) even before the Covid-19 crisis (see Figure 2b). The strict lockdown resulted in a further plunge in South Africa PMI. The country recorded a 98.4% decline in the sale of new vehicles in April and 86.3% in May from a year ago. The lockdown also had a material impact on the consumer-cyclical sector with about 40 bps increase in Agg PD. The sector is mainly comprised of retailers and distributors which were assessed as low risk pre-Covid-19. Nevertheless, the industrial and consumer-cyclical companies are now gradually recovering though the fundamental pre-Covid-19 challenges remain for the industrial sector.

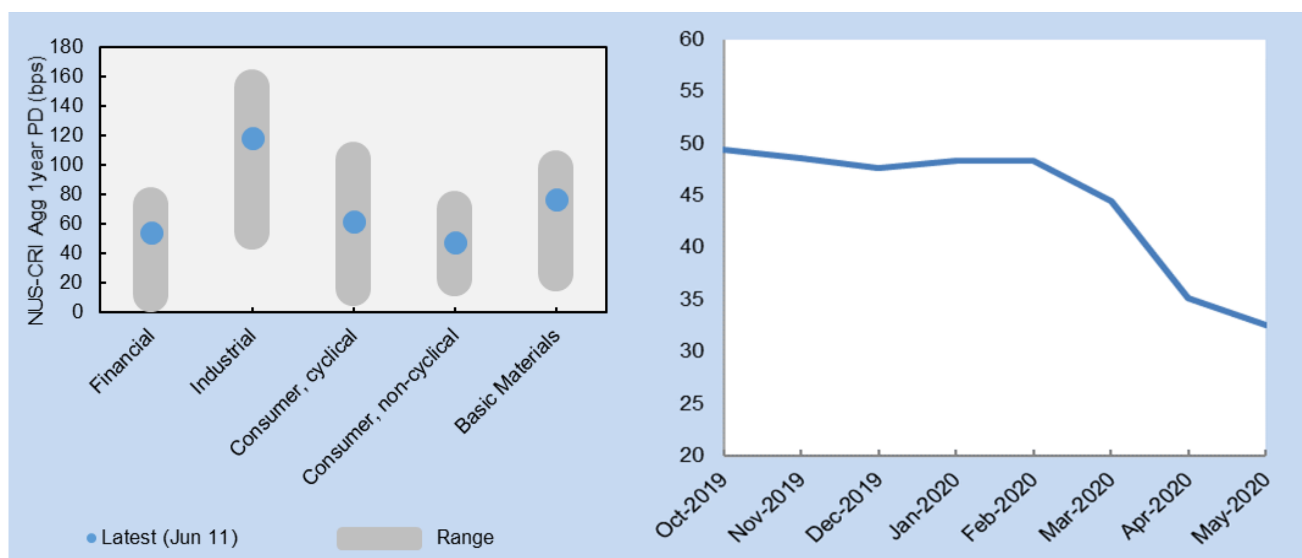

Figure 2a (LHS): NUS-CRI Aggregate 1-year PD for South African listed companies in five sectors with the range from October 2019 with the lowest point mostly recorded in February and the highest point during March and April; Figure 2b (RHS): IHS Markit's South Africa Purchasing Managers' Index. *Source: NUS-CRI, IHS Markit.*

Basic materials is another sector that experienced a material increase in risk post-Covid-19. The sector's higher risk is not surprising considering the fall in global demand and commodity prices as well as disruption in mining due to lockdown and logistics challenges. The export of mineral products, which includes coal and iron ore, dropped by 39%, while precious metals and stones and base metals fell by more than 60% during the month of April. The Covid-19 related challenges are in addition to the ongoing issue of heavy unionization in this sector which results in an inflexible labour situation. At the same time, the sector did benefit from some companies being involved in gold mining who registered an average increase of only 10bps in Agg PD. This is because gold prices have risen as it is perceived as a safe haven during times of financial market stress.

Conversely, the two sectors registering the lowest risk currently are non-cyclical consumer companies and financial companies. The non-cyclical consumer companies, which mainly comprise of non-cyclical consumer goods companies as well as pharma companies, benefit from inelastic demand and were generally classified as essential services by the government. They were therefore not much impacted by the lockdown. Also, the financial sector in South Africa, particularly banks, are much better positioned to withstand the credit losses and potential drop in deposits due to lower

interest rates and lower household disposable income. This is because of their strong capitalization levels, proactive regulatory measures to support banks through measures like capital relief and liquidity measures as well as limited exposure to international funding.

Going forward, the risk for the companies listed in South Africa is expected to remain elevated compared to the pre-Covid-19 levels. As exhibited by the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[2]) in Figure 3, we expect the Forward PD to remain in the range of 70-90 bps as compared to its pre-Covid-19 Agg PD level at around 25-35 bps. This potentially reflects the financial markets' concern with the increasing rate of Covid-19 infections and deaths in the country. It also reflects the inherent challenges in doing business in the country, which continue to constrain the country's economic growth and thereby posing a risk to local companies. Nonetheless, the risk is expected to be much lower than the one faced by companies in Brazil where the Forward PD materially increases over the next 2 years. This could be because Brazil, in addition to some of the issues being faced by South Africa, is also facing political instability which in the past has resulted in severe economic challenges and a relatively much worse Covid-19 crisis.

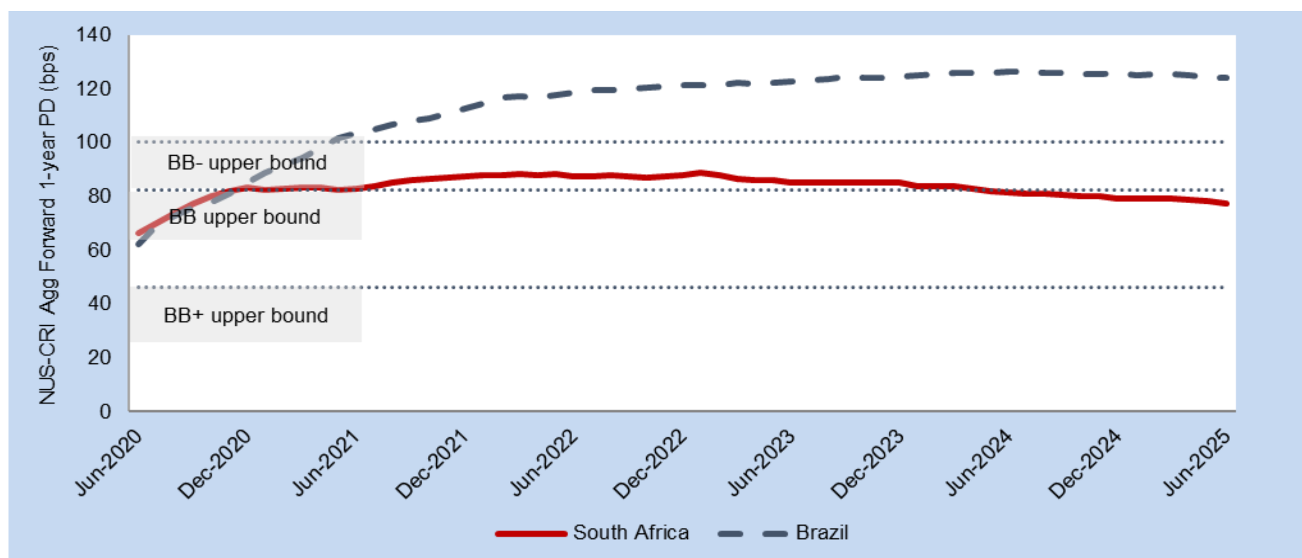

Figure 3: NUS-CRI Aggregate Forward 1-year PD for South Africa and Brazil as of June 2020 bounded by PDiR2.0. *Source: NUS-CRI*

[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar 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.

Credit News

Foreign businesses hit bonanza in US credit markets

Jun 19. Droves of foreign companies are raising US dollars to capitalize on low borrowing costs and roaring investor demand for corporate debt. Consequently, the sales of dollar bonds by overseas firms in April and May reached the highest level in seven years. American companies are also opting to raise capital at home and selling bonds denominated by euros. This is largely because of the Fed's action, which signaled the Fed's willingness to keep credit flowing to American corporations. The rush by overseas firms to borrow in the US is adding to the pile of debt that American companies have issued since the Fed's intervention to credit markets in March. (WSJ)

US corporate borrowing costs sink to record low

Jun 19. Purchases of US corporate debt by foreign investors almost doubled from March (USD 6.5bn) to April (USD 11.6bn), pushing the yield on higher quality debt to a new record low, according to government data. Throughout May and June, demand from foreign investors remained strong while the US Federal Reserve implemented monetary easing. One of the main reasons for the increase in foreign demand is because of the significant fall in the cost of converting US dollar-denominated debt back into other currencies following the Fed's slash of the US interest rates. This reduces the cost of entering into derivatives contracts and brings down the cost of hedging currency risk. Although the falling yields on US corporate bonds have narrowed the difference in returns of US and local corporate bonds recently, the demand for US corporate bonds is expected to remain strong as long as the Fed held rates near zero. (FT)

Banks rush to borrow record EUR 1.3tn at negative rates from ECB

Jun 18. To boost liquidity in the eurozone's economy, the ECB introduced the dual-rate system that offers ultra-cheap multiyear loans, i.e., loans at an interest rate below its main deposit rate. This inflates the central bank's balance sheet to above EUR 6tn in total. By now, 742 banks applied to borrow EUR 1.3tn from the ECB, which will lend them money over three years at minus 1 percent interest rates, providing they meet certain lending thresholds. The banks will use about EUR 760bn of these loans to repay earlier ECB loans that are about to mature. Most of the remaining money is expected to be used to buy bonds issued by their own governments. This will yield the banks an instant profit since the yield on government bonds is much higher than the negative rate from the ECB. (FT)

Debt investors let borrowers go back to future

Jun 17. To avoid potential debt breaches, some companies that suffered plunging revenues because of Covid-19 do not use their actual numbers in documents they present to lenders. Instead, they either use 'ebitdac' (earnings before interest, tax, depreciation, amortization and coronavirus), i.e., the estimated profits companies would have made without the virus, or they use historical figures. Despite the critique for using numbers that ignore the impacts of Covid-19, many debtholders have so far accepted it since acknowledging depressed 2020 earnings could cause problems on both sides: There would be more restructuring scenarios which are not in the interest of bondholders and creditors. (FT)

US companies near 2019 bond-issuance total with coronavirus binge

Jun 16. Highly-rated US companies have issued nearly as much debt this year as they did in the whole of 2019, building large cash reserves to ride out the coronavirus crisis and taking advantage of cheap borrowing costs in a market boosted by central bank assistance. However, the pace of new issuance is expected to slow down in the coming months, as many big borrowers have already topped up their coffers. Though average investment-grade yields rose last week, some analysts expect borrowing costs for top-rated companies to resume their decline, as investors will continue to seek income at a time of rock-bottom rates on the safest of assets. (FT)

PG&E says bankruptcy court approves its Chapter 11 reorganization plan (Reuters)

Chesapeake Energy skips interest payment; borrowing base slashed (Reuters)

BP raises USD 12bn in wake of multibillion-dollar write-down (FT)

Regulatory Updates

Bank of England boosts bond-buying by GBP 100bn but slows the pace

Jun 19. The Bank of England's decision to increase quantitative easing through pumping GBP 100bn reflected continued concern about the strength of the economic recovery, despite the central bank now thinking that the fall in April's output to be much milder thus slowing the pace. Now, it plans to reduce the pace of asset purchases by two-thirds from GBP 13.5bn to an average GBP 4.5bn for the rest of the year. The BoE governor explained that the move was because- although the economy in the UK and globally was healthier than expected, the outlook in the medium term continue to be pessimistic, especially for the labor market. This decision by BoE to slow the pace of QE while increasing the amount has brought about confusion in the financial markets as to the Bank's intentions. However, some believed it was to quell disorder in the financial market and still provide monetary stimulus. Currently, interest rates continue to remain at a historic low of 0.1% with no intention of going into negative territory. Many analysts expect more aggressive QE in the coming year. (FT)

UK regulator permanently bans marketing of mini bonds

Jun 14. Britain's financial regulator plans to ban the marketing of high-risk "mini bonds" to retail investors permanently, after about 12,000 pensioners and small savers lost GBP 236mn in the collapse of London Capital and Finance. Retail investors may not be offered unlisted bonds that are used to fund a third-party business, to buy or fund the construction of a property, or to buy or acquire other investments under the ban as these types of investments are not traded in exchange, thus making it difficult for investors to sell up. The new rules will allow mini bonds and some high risk listed bonds to be promoted only to investors that are clarified as "sophisticated or high net worth". (FT)

Russia cuts rate most in five years and signals more easing (Bloomberg)

SNB joins central banks cutting dollar liquidity operations (Reuters)

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