Credit outlook for UK firms is worsening relative to its EU peers amid Brexit uncertainty

by Liu Hanlei

UK PM Theresa May will be presenting her revised Brexit deal in Westminster for a meaningful vote on 12 Mar. The revised deal with EU was agreed on 11 Mar after near-collapse negotiations between the officials just a day earlier. If the PM's revised deal was defeated, two more votes would be conducted, on whether to leave EU without a deal and on whether to delay Brexit date, 29 Mar. Amid the uncertainty of Brexit, UK's bond market see fewer bond deals. For the first two months of 2019, only 40 new bond deals in the UK were completed, the lowest since 1995 according to data from Refinitiv with total proceeds at USD 26bn, down by half compared to a year ago. Bond yields of high yield GBP bonds have also risen as compared to the start of 2016 when UK's previous PM David Cameron talked about holding a referendum on Brexit.

By using the NUS-CRI Forward 1-year Probability of Default (Forward PD), a direct comparison of credit outlook can be made between UK and EU 27 (EU members except for the UK) domiciled firms. As seen in Figure 1a below, the NUS-CRI Forward PD for UK firms is increasing faster than its EU 27 counterparts and is diverging based on the market information available on 8 Mar 2019. The Forward PD computes the credit risk of a company or a portfolio of companies in a future period, which can be interpreted similar to a forward interest rate. For example, the 10-month forward 1-year PD is the probability that the firm defaulted during the period from 10 months onwards to 1 year plus 10 months, conditional on the firm's survival in the next 10 months. Comparing to the Forward PD based on market information available on 4 Jan 2016, the Forward PD for UK and EU 27 is almost similar with little divergence. This may mean that the impact of Brexit on UK companies' credit profile could be long-term, given that Brexit may led to imposition of tariffs and hit cross-border supply chains if there are delays at borders, loss of access to other markets and disruptions to financial markets.

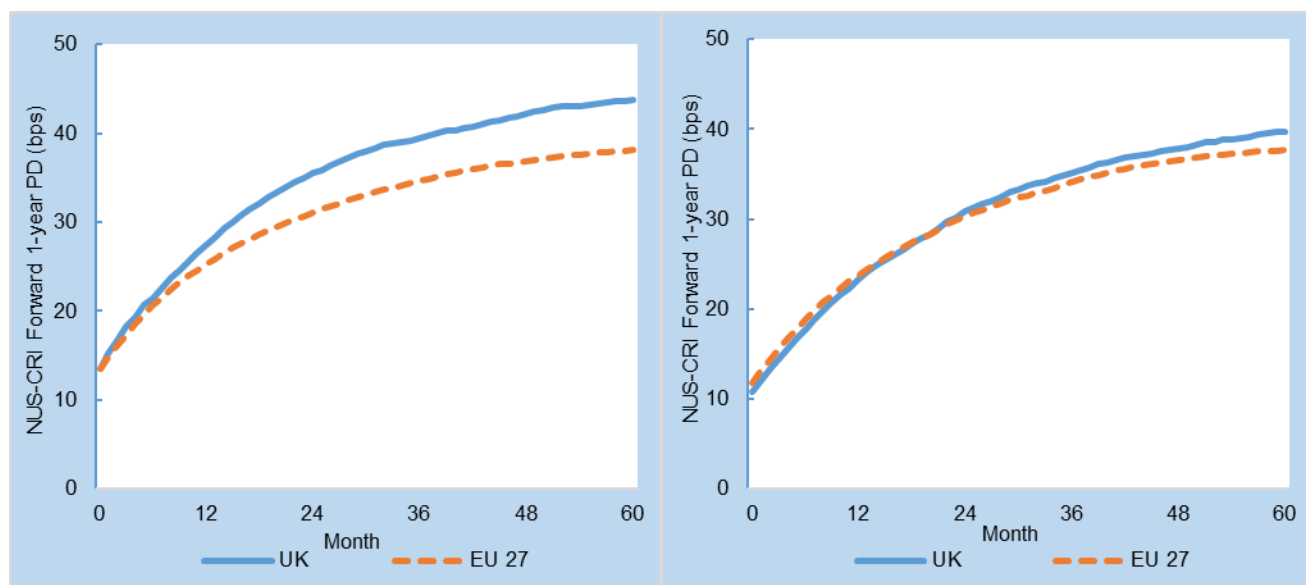

Figure 1a & 1b: NUS-CRI Forward 1-year PD for UK and EU 27 domiciled firms based on market information on 8 Mar 2019 (LHS) & 4 Jan 2016 (RHS). *Source: NUS-CRI*

From the bond market perspective, the option adjusted spread (OAS) for GBP high yield (HY) bonds have reached to an elevated level of 579bps on 8 Mar as seen in Figure 2 below. The OAS for GBP investment grade

(IG) bonds have also reached its high since Dec 2016 at 141bps on 8 Mar. One observation is that the yield spread between GBP HY and GBP IG has increased during this period, potentially signifying the increased credit risk associated with junk rated GBP issuers. Even though the OAS between bonds of different currencies should not be compared as there is a need to consider the expected return on the exchange rate and other risk, some market participants may use this difference to have a rough idea of the risk premium demanded for certain bonds. Therefore, the OAS for EUR bonds is also presented in Figure 2 for reference and it shows that the OAS EUR HY bonds is at 424bps, while the OAS for EUR IG is at 80bps on 8 Mar.

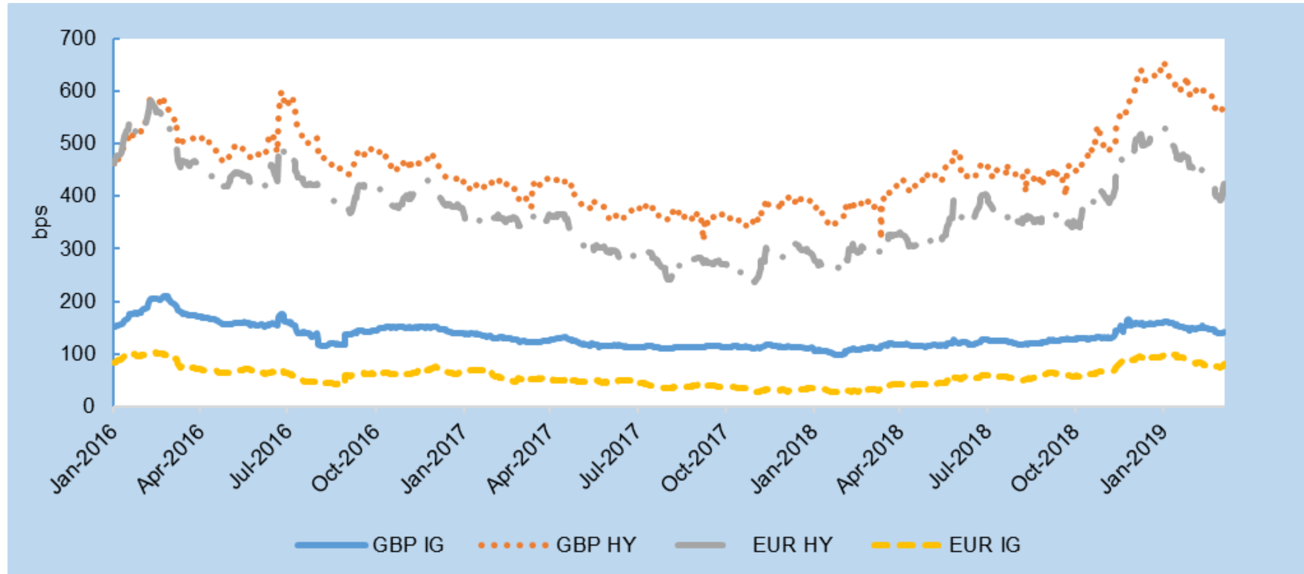

Figure 2: The option adjusted spread (sovereign) for GBP denominated IG, HY and EUR denominated IG, HY bonds from 4 Jan 2016 to 8 Mar 2019. *Source: Bloomberg*

In addition to the potential higher debt financing cost associated with increasing credit risk, UK firms have more than USD 130bn of debt maturing in 2019 and the total net debt on UK firms' balance sheets is at a new high, comparing to the past ten years, standing at about GBP 400bn, according to data compiled by Link Asset Services. For the next 5 years, UK firms will see an average of USD 136bn of debt maturing each year as seen in Figure 3 below. Analysts are also expecting UK companies to have one of the weakest earnings growth among major economies for 2019 at 3.2% growth. In all, the increasing credit risk coupled with weak earnings growth expectation put UK firms in a tough position.

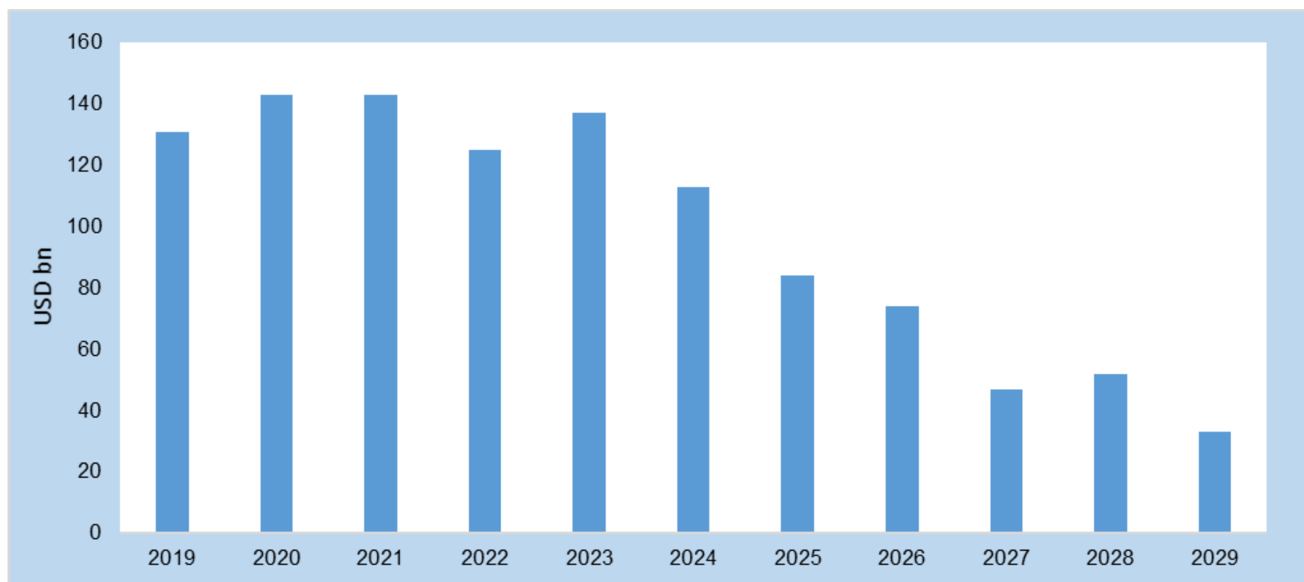

Figure 3: Annual debt maturities for UK firms. *Source: Refinitiv*

Besides the much discussed business risks posed by the uncertain Brexit, the potential increase in debt financing cost will add burden to UK firms with its relatively high debt on balance sheet. The slowdown in UK's economy is also not helping matters. With the risk of a no-deal Brexit still on the cards, UK companies' credit outlook will worsen as compared to its European counterparts in the medium to long run.

Credit News

Airbus chief signals tough stance on A380 loans

Mar 11. As a result of a failure to win new orders, the leaving chief-executive Tom Enders of Airbus has announced an early discontinuation of its A380 airliner production in 2021. This has ramifications for the governments of Germany, Britain, France and Spain, who had invested heavily into the development of the A380 and are now facing large unpaid debts, the exact height of which are unknown but which are estimated to lie in the hundreds of millions of Euro. Since repayments of "repayable launch investments" (RLI) are contingent on airline sales, Enders said, the governments had willingly undertaken this risk. Previous governmental RLI into the development of the A320 had been profitable. (FT)

Debt catches up with Turkey

Mar 11. Turkey has entered into a recession following a currency crash, policy missteps and an unprecedented diplomatic rift with the US. An era of record monetary stimulus in the past ten years has supercharged Turkish companies, more than doubling corporate credit, and investors are worrying that Turkey will face a long slog to recovery as the torrent of foreign capital dries up while households and companies begin paying down debts. The government has heaped pressure on state banks to ramp up credit in an effort to restart debt, but the outlook remains bleak for now. As the central bank holds interest rates high to stabilize the lira and keep inflation in check, the engine of Turkey's economy is misfiring. With a total debt at 121 percent of GDP, the ratio of non-performing loans may climb to about 7 percent this year from around 4 percent and Turkey's largest companies have either completed or sought almost USD 24bn of loan restructurings. (Bloomberg)

Mizuho foreign-bond misadventure follows mass Japan shift abroad

Mar 7. With a deposit surplus and low borrowing rates at home, Japanese financial institutions have been purchasing overseas assets in the past decade. Extremely low interest rate for many years contributed to the accumulation of about USD 1.3tn foreign bonds on the banks' balance sheets, according to Morningstar. Among them, JPY 37tn (USD 331bn) in foreign bonds were held by Mizuho, and two other Japanese megabanks as of December. Last Wednesday, about JPY 150bn of a "negative carry" from foreign bond holdings was charged by Mizuho. Negative carry refers to returns that fail to exceed the cost of financing the purchase of an asset. (Bloomberg)

China's local government financing vehicles are now darlings of bond market

Mar 5. Amid a slowing economy and rising corporate default rates in the past year, the Chinese financial markets have turned their eyes on Local Government Financing Vehicles (LGFVs) as an attractive bond alternative. With risk-free interest rates at low levels and appropriate high-yield investment opportunities rare, lower-rated LGFV-notes are currently in high demand. The attractiveness of LGFV bonds is partly due to the fact that compared to numerous private company defaults, there has not been a single LGFV bond default so far. However, this is mainly due to an ongoing government bailout policy, which involves the hidden risk of an unclear policy end date. (Business Times)

Moody's lowers Singtel outlook to 'negative' on price war and Bharti debt

Mar 5. Moody's has downgraded its outlook on Singtel to "negative" from "stable", on concerns over price competition in Singapore and Australia and on the back of the expectation that Singtel will partially or fully subscribe to its portion of a multibillion-dollar rights issue at debt-hit Indian associate Bharti Airtel. Bharti Airtel's latest fundraising exercise could put the A1 rating at risk if it raises Singtel's net leverage from around 2.2 times to 2.4 times. Moody's said that Singtel's outlook could be returned to "stable" if the company's overall profitability improves and borrowings are reduced. Moody's also reaffirmed Singtel's A1 rating reflecting the company's leading market positions and regionally diversified cash-flow stream from its ownership in various Asian mobile associates. (Business Times)

Europe's most important bond edges back towards negative territory (WSJ)

Jeans maker Diesel USA files for bankruptcy (Reuters)

Temasek's triple A rating backed by strong credit profile, high quality portfolio (Straits Times)

Regulatory Updates

BoE tightens bank liquidity buffers before Brexit

Mar 11. The Bank of England has told some UK lenders to triple their holdings of easy-to-sell assets in the run-up to Brexit to cope with a market meltdown if the UK crashes out of the EU without a deal later this month. Banks are also being forced to model their balance sheets on the assumption that they will not be able to swap sterling for dollars. The central bank is monitoring lenders' liquidity levels daily or even more frequently. The Liquidity Coverage Ratio has been extended by the authorities from normal 30 days to 100 days for some institutions and the policy for banks' liquidity requirements are different for each institution. (FT)

EBA publishes final guidelines on the estimation of LGD under an economic downturn

Mar 6. The European Banking Authority (EBA) has published its final guidelines for financial institutions on the estimation of Loss Given Default (LGD) during an economic downturn. As a goal of the EBA, this amendment to its earlier published rule framework aims to standardize practices for internal estimation models. Included in the new guidelines are three possible approaches for LGD estimation, the choice of which depends on the available loss data for the current economic downturn, as well as further details regarding their implementation. The new rules will come into effect from January 1st, 2021, but an earlier implementation and adequacy checks are recommended by the EBA. (EBA)

Federal Reserve scraps 'qualitative' test for US banks in 2019 stress tests (Reuters)

RBI may bar dual functions of rating agencies (Economic Times)

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