Differing robustness drives opposing credit outlook for Russian and EU energy companies

by Wang Nan

- **The NUS-CRI Agg Forward PD indicates that the heightened credit risk is poised to taper in the long term given the demand from potentially substitute markets such as China and India, and the likelihood of further government intervention to improve the operating environment for Russia's strategic industry**
- **Stress testing shows that the credit health of EU gas distributors is vulnerable to sanction-driven supply shocks, in line with NUS-CRI Forward PD for the industry**

As major western economies officially announced the ban on the import of Russian oil and gas on 8th March 2022, the credit health of Russian oil and gas companies came under pressure, while the fallout of the new sanctions simultaneously affected the credit risk of downstream EU gas distributors. The NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) of Russian oil and gas companies in Figure 1a[1] showcased a sharp deterioration in credit health as the volatility in the Russian financial markets threatened the financial health of the industry, especially as concerns regarding operational and financing viability dominated investor sentiment. Operationally, the impact of the initial sanctions primarily dampened the revenue generation capabilities of Russian oil and gas companies due to widespread import bans. Looking forward, although the sanctions on these companies are set to continue eroding their operating conditions in the short term due to reduced exports and discounted oil price, the NUS-CRI Forward 1-year PD[2] (See Figure 1b) suggests that sanctions' effect on the credit health of Russian oil and gas companies may be transitory in nature, possibly owing to the anticipated government intervention in consideration of the industry's strategic importance to domestic economic growth and its heavy interconnection with the rest of Europe, and vis-a-vis, the rest of the world.

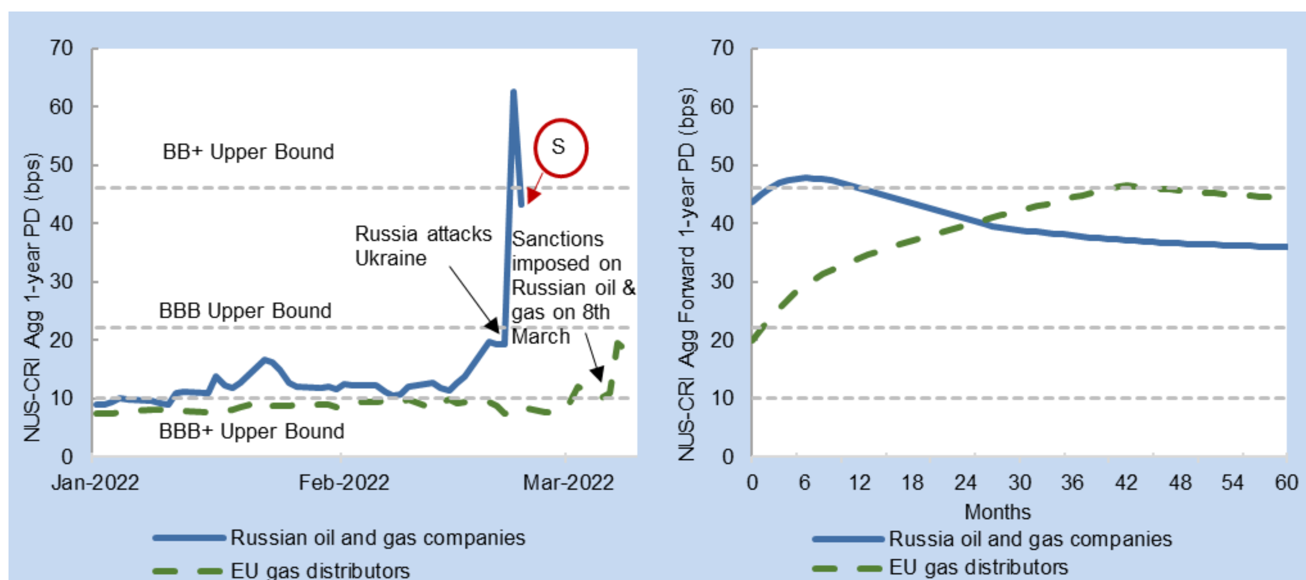

Figure 1a (LHS): NUS-CRI 1-year PD for Russian oil and gas companies and EU countries' oil distributors from Jan-2022 to Mar-2022 with reference to PDiR2.0[3] bounds. All Russian oil and gas listed companies were last updated on 25 Feb due to suspension of trading by the Moscow Exchange. Figure 1b (RHS): NUS-CRI Agg Forward 1-year PD for Russian oil and gas companies and EU countries' oil distributors as of Feb 25th 2022 and Mar 11th 2022 respectively. *Source: NUS-CRI*

[1] As Moscow Exchange suspended trading on all markets, the PD of Russian companies remained unchanged from Feb 25, 2022.
[2] 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.
[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.

Aversion to Russian oil and gas has built up in response to the escalating tension between Ukraine and Russia leaving potential revenue[4] in limbo, with almost 70% of Russian crude oil exports unmarketable. After the declaration of the official sanctions, Russian oil and gas exports are expected to face more headwinds in the short term. Such export bans could potentially remove over 40% of Russia's total oil exports from trade, which could lead to loss of revenues and reduced operating cash flows. Meanwhile, EU gas distributors, whose oil and gas imports from Russia are 27% and 40% respectively, saw their credit risk elevate due to a potential sanction-driven supply shortage as shown by the recent jump in Agg PD (See Figure 1a). Should Russian energy exports to the EU be cut off in the medium-to-long term, EU gas distributors would face severe operational risks with respect to finding alternative oil sources to fill the supply gap. The continued impact of the sanction-driven supply shock on EU gas distributors can be simulated using the Bottom Up Default Analysis toolkit (BuDA[5]). Figure 2a showcases the impact on Agg PD due to oil prices rising and then stabilizing[6] in Dec-2022, as supply chain bottle-necks continue to limit the supply of Russian oil and gas into the EU. Vulnerable firms in the industry are poised to face heightened credit risk near the end of the year, as they may be less geared to handle the transition to alternative sources of oil and gas over such a short period. Non-vulnerable distributors' credit risk remains relatively unchanged[7].

The import bans from the US are effective immediately. However, the US only consumes 1.3% of Russia's total oil export, indicating that Russian oil and gas companies will remain relatively unscathed by US bans. In contrast, the EU phase-out of Russian oil will take close to a year to implement, emphasizing that the interdependencies between the EU and Russia may make it difficult to completely switch from Russian oil and gas to other sources. Therefore, the bans may not pose immediate effects on the revenue of Russian oil and gas companies, which may help mitigate some future credit risk for these companies as suggested by the downward sloping trend of Forward PD.

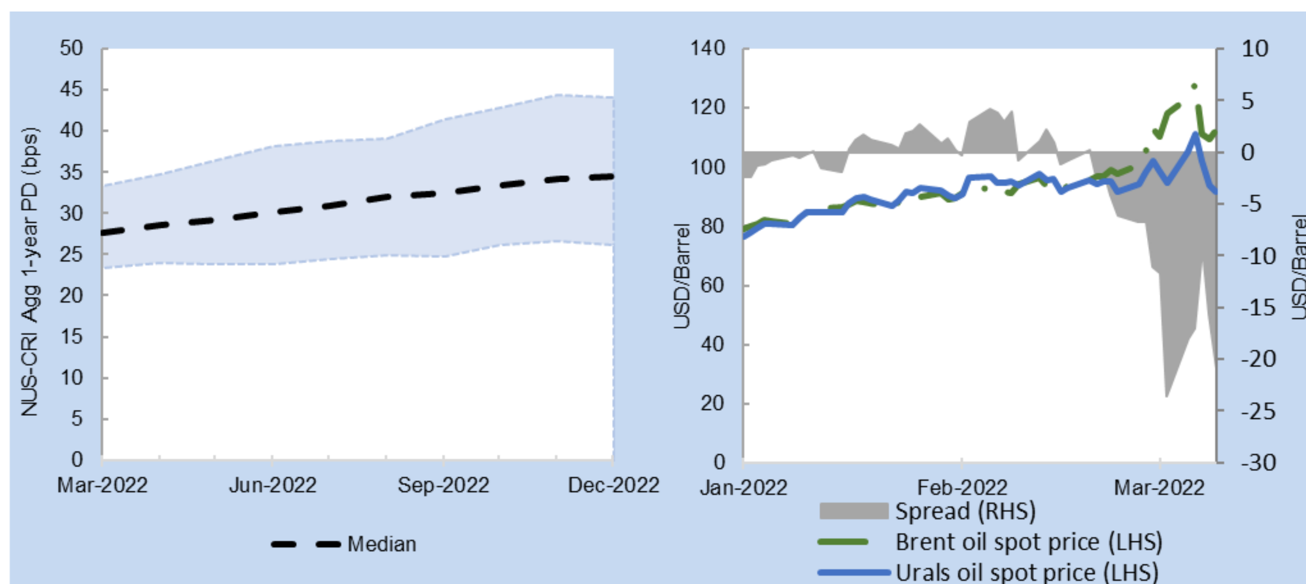

Figure 2a (LHS): NUS-CRI Agg 1-year PD (Median and interquartile range) of EU gas distributors stressed against oil prices and inflation levels. Figure 2b (RHS): Crude Oil Urals Europe CFR Spot price, Brent Crude oil spot price, and the difference between Urals and Brent oil price showing that Urals oil is experiencing a huge discount compared with Brent oil. *Source: BuDA v3.3.0, Investing.com, Insider*

Currently, Russian oil and gas companies do not enjoy the full benefits from soaring global oil prices as Russian Urals crude price is deeply discounted to Brent due to the clear unwillingness of the market to take Russian crude (See Figure 2b). Should the Urals oil price continue decreasing, as markets would likely further discount Russian crude, the reduced exports together with discounted price would hinder Russian oil and gas companies' operating revenue from exports.

Furthermore, major Russian oil and gas companies still need to fulfil their repayment obligation for foreign-denominated bonds maturing in the short term. Foreign-denominated debt owned by Russian oil and gas companies accounts for half of all debt owned by Russian corporations, amounting to close to USD 98bn, of

[4] About 60% to 70% of oil produced by Russia is exported.
[5] The Bottom-up Default Analysis (BuDA v3.3.0) is a credit stress testing and scenario analysis toolkit jointly developed by the Credit Research Initiative (CRI) team of National University of Singapore (NUS) and the International Monetary Fund (IMF).
[6] Rate of oil price increase decreased over the next 8 months from 20% MoM in Mar-2022 to 0.5% MoM in Dec-2022, with inflation levels rising by 1% MoM.
[7] Shaded area in Figure 2a represents the bounds between the 75th percentile (Vulnerable firms) and 25th percentile (Non-vulnerable firms).

which close to 17% matures within a year. Although firms with significant revenues in foreign currency may be able to service their debt, the ruble depreciation, in conjunction with the Bank of Russia's capital control policy, puts further pressure on oil and gas corporations' foreign-debt repayments. To add to their woes, sanctions against Russian companies make refinancing through new bond issuance denominated in foreign currency highly unlikely in the foreseeable future.

In the long term, as Russian oil and gas companies look for alternative export trade routes, they may turn to China and India. Firstly, oil and gas exports to China are expected to expand after major Russian oil producers, including Surgutneftegaz and Transneft, bared plans to increase business with China. Moreover, India is also willing to take up a Russian offer to buy crude oil at discounted prices, which could make up for potential revenue loss due to Western sanctions[8]. Secondly, the removal of several major Russian banks from SWIFT compelled oil and gas companies to migrate to other unrestricted financial networks. Meanwhile, China's UnionPay and India's proposed rupee-rouble mechanism offer promising alternatives to facilitate smooth bilateral trades. Furthermore, as oil and gas export is an important revenue stream for the Russian government, increased government intervention is highly likely to prevent further financial distress to the country's largest state-owned companies, as well as to mitigate the threat of a domestic financial crisis. As such, the impact of Western sanctions on the credit health of Russian oil and gas companies can be mitigated on the back of demand from potential substitute markets and government intervention.

[8] The nature of the partnerships between China, India and Russia are currently unknown. Thus, the conclusion on whether they will be apt substitutes to completely mitigate the loss of EU export revenue remains uncertain. However, it is a credit positive for Russian oil and gas companies.

Credit News

Europe's riskiest bonds plunge as ECB ramps up tightening pledge

Mar 10. ECB's accelerated exit from extraordinary stimulus sends a signal that it will start raising interest rates sooner than it initially intended, to curb inflation brought about by rising energy and commodity prices. Because the stimulus plays a major role in keeping the borrowing costs for the riskiest countries reasonable, investors could view ECB's exit as a reversion of credit risk that requires adjustment and realignment of yields. This surge then would normally cause the price of the riskiest bonds to plummet. The speed of policy changes could trigger concerns on debt sustainability, especially for countries were viewed as vulnerable prior to ECB intervention. (Bloomberg)

Bond investors left in the dark after some Russian borrowers pay up

Mar 11. Gazprom's repayment of USD 1.3bn bond has come as a surprise to investors who have been expecting Russian companies to default driven by sanctions imposed by the West. Russian companies have USD 98bn of foreign currency-denominated bond outstanding, with almost half due in the coming 3 years. The unexpected bond payment seemed to be an indication that firms with footprints outside Russia that have significant foreign currency revenues may be able and willing to repay debt. However, investors are reluctant to assume the same level of willingness towards repayment of foreign currency obligations on part of overall Russian corporates, especially as the Russian government is expected to default in the coming weeks. While companies may continue to service debt using overseas funds, investors remain uninformed regarding payment until the last moment. (FT)

Cash hoarding by Canada firms heats up as Ukraine war rages

Mar 9. As fears of the crisis getting worse mount, institutions have opted to maintain a comfortable liquidity buffer for themselves by issuing bonds, even when doing so meant taking on higher borrowing costs. The spread between corporate and government bonds has widened in response to the perceived heightened credit risk posed by the war, with investors demanding extra yields to compensate. Given the uncertainty of the situation, the sooner the financing is obtained, the better. (Bloomberg)

Historic commodity rally sends trading houses hunting for credit

Mar 8. Commodity trading houses around the world have been forced to hunt for additional capital as the Russia-Ukraine conflict causes commodity prices to soar, putting a strain on the trading houses' credit limits. The news of the Biden administration considering a ban on Russian oil import propelled commodity prices even higher with oil, gas, nickel, aluminum, palladium, and wheat registering record or multi-year highs. The soaring prices mean that traders need additional margin to cover their positions. The simultaneous increase in the cost of shipping oil, metals, and crops adds to the burden on their finances. (Bloomberg)

China credit growth slows more than expected despite easing

Mar 11. Demand for mortgages seems to have grown unresponsive to the policies employed by the People's Bank of China and other lending institutions. The lowered interest rates and relaxed loan requirements were intended to induce borrowing, hype the housing market, and propel economic recovery. However, the results are unimpressive compared to historical data underscoring the public's reluctance to take on new commitments. The 5.5% growth target of the economy could prove to be a challenge, especially amidst the Russia-Ukraine war and the resurgence of coronavirus infections, unless the central bank steps in and boosts its policies to ensure that the target would be achieved. (Bloomberg)

Cracks appear in global credit markets as investors dump assets (Bloomberg)

UniCredit warns EUR 7bn at risk in 'extreme scenario' of Russia unit being wiped out (FT)

Chinese nickel giant secures bank lifelines after epic squeeze (Bloomberg)

Regulatory Updates

Hawks in control at ECB as inflation fears dictate policy shift

Mar 11. The recent ECB meeting saw shift of control to hawkish officials as the possibility of high inflation loomed. Although several ECB members advised against a step up in the withdrawal of bond-buying citing a possible adverse fallout from the Russia–Ukraine crisis, they were surpassed by the more hawkish members, with the inflation argument taking precedence over the war and uncertainty about growth. Consumer prices registered a record annual rate of 5.8 % in February and have been beating ECB expectations for several months now. Eurozone government bonds experienced a sell-off following ECB's announcement of a quicker reduction in asset purchases. (FT)

Russia lost access to half its reserves; Finance Minister says

Mar 13. One of the heaviest sanctions imposed on Russia was the asset freeze on its central bank for the purpose of stifling the financial system, rendering a significant portion of its reserves, amounting to approximately $300 billion, inaccessible. The restriction, along with the other sanctions, delivered a massive blow to the economy and sparked concern about Russia's ability to repay its debts. Notwithstanding, the West is determined to isolate Russia completely, directing pressure on China, who had offered a lifeline to Russia by not only keeping commerce between the countries open but also with the possibility of expanding it. Data published by Russia earlier disclosed that 13.1% of its reserves (as of June 2021) were denominated in yuan. A pivot of China in support of the West could further push Russia's economy downhill. (Bloomberg)

New Zealand banks urge RBNZ to delay new lending restrictions (Bloomberg)

Banks told to provide information on oligarchs under sanctions (FT)

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