Credit risk outlook for major Indian fuel retailers set to worsen as rising oil prices pressure margins

by Amrita Parab

- **NUS-CRI Agg PD of Indian fuel retailers trends upwards as unchanged local retail fuel prices depress margins, especially as cost of sourcing oil in the global market skyrockets**
- **NUS CRI Agg Forward PD suggests that margin woes are set to continue raising credit risk for major fuel retailers, especially as both domestic and foreign debt servicing capabilities may be hindered**

Record-high crude oil prices have landed Indian fuel retailers in hot water. Having kept fuel prices unchanged for the past few months due to pressures surrounding local elections in spite of a sharp increase in global crude prices, Indian fuel retailers finally announced a price hike on Mar 22, the first such hike since Nov-2021. This hike was subsequently followed by six consecutive price hikes within a week as retailers try to recoup losses that had surmounted since the end of last year. The inability to react to the rising global price of crude oil has had an adverse impact on their margins, resulting in heightened credit risk for the three major Indian fuel retailers[1]. The NUS-CRI Aggregate (market cap weighted average) 1-year Probability of Default (Agg PD) for these major fuel retailers in Figure 1a showcases an increase in Agg PD since the end of Oct-2021, concurrent with their inability to respond to higher crude oil prices. The NUS-CRI Agg Forward 1-year PD[2] (See Figure 1b) in Mar-2022 also demonstrates an increasing trend as the sanctions on Russian oil & gas increases the possibility of a supply-side shock and threatens to push global crude prices higher, adding further stress to Indian fuel retailers' liquidity and narrowing margins.

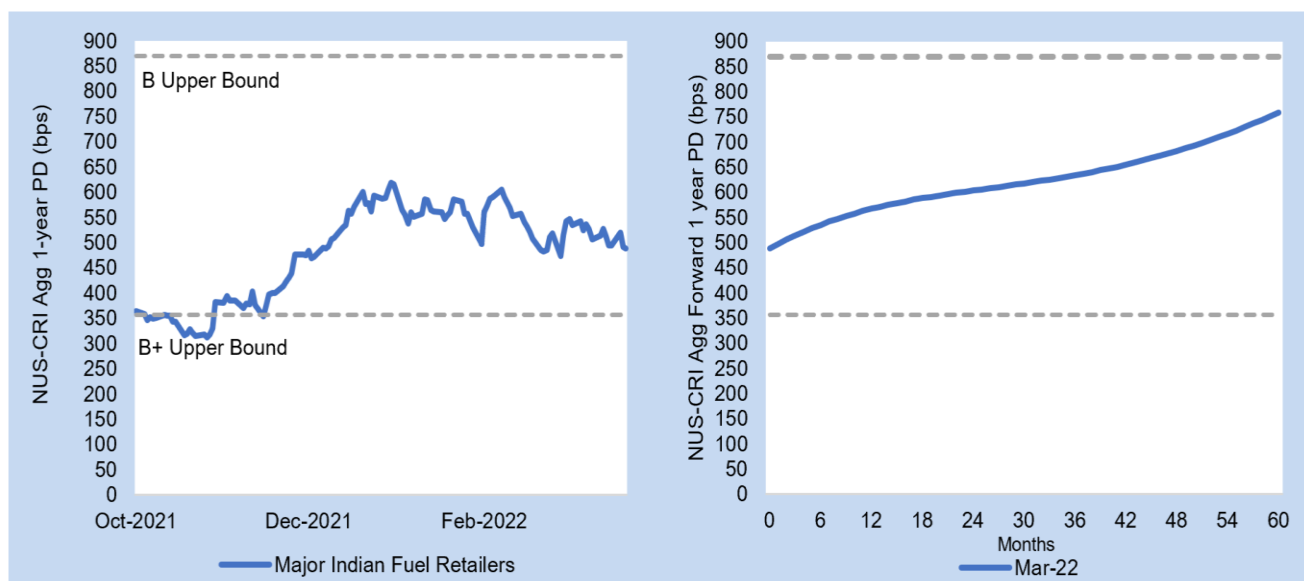

Figure 1a (LHS): NUS-CRI Agg 1-year PD for major Indian fuel retailers from Oct-2021 to Mar-2022 with reference to PDiR2.0[3] bounds. Figure 1b (RHS): NUS-CRI Agg Forward 1-year PD for major Indian fuel retailers as of Mar-2022. *Source: NUS-CRI*

[1] The sample consists of Indian Oil Corp Ltd (IOCL), Bharat Petroleum Corp Ltd (BPCL), and Hindustan Petroleum Corp Ltd (HPCL). These state-owned retailers account for 90% of India's retail market.

[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.

Indian fuel retailers depend on imports for the majority of their crude oil requirements and therefore, are highly sensitive to increases in the price of global crude oil. Hence, since 2017 India's state-owned fuel retailers moved to daily price adjustments in order to improve their ability to react to global changes in fuel price and protect their margins. However since Nov-2021, with the local state assembly elections in Q1 2022, fuel retailers abruptly stopped daily price revisions to assuage the Indian consumer. Concurrently, since the halt in price revision, the global oil price saw an increase of around 45% to 119 USD/barrel, pinching the Indian fuel retailers' margins and leading to estimated foregone revenue of USD 2.5bn. According to information from the Petroleum Planning & Analysis Cell, the Indian basket of crude oil, which is representative of the retailer's cost, reached close to 118 USD/barrel in Mar-2022, the highest level since 2012. At current price levels of crude oil, the firms are absorbing losses of approximately USD 65 - 70mn/day. Currently, despite the recent price hikes, the still suboptimal retail prices may potentially lead to an increase in short-term borrowing to fund their rising working capital requirements.

India being the third-largest importer of oil in the world, the jump in oil prices has also led to a subsequent deterioration of the Indian Rupee (INR). The INR registered a record low exchange rate against the US dollar in Mar-2022 driven by Russian-Ukraine geopolitical tensions and a stronger US dollar. The currency deterioration adds to the burden of foreign debt obligations of the companies which account for approximately 50% of total debt maturing in 2022 alone. While HPCL's debt is sufficiently isolated from currency fluctuations in the near term, all BPCL's debt and about 70% of IOCL's debt maturing in 2022 are denominated in foreign currencies.

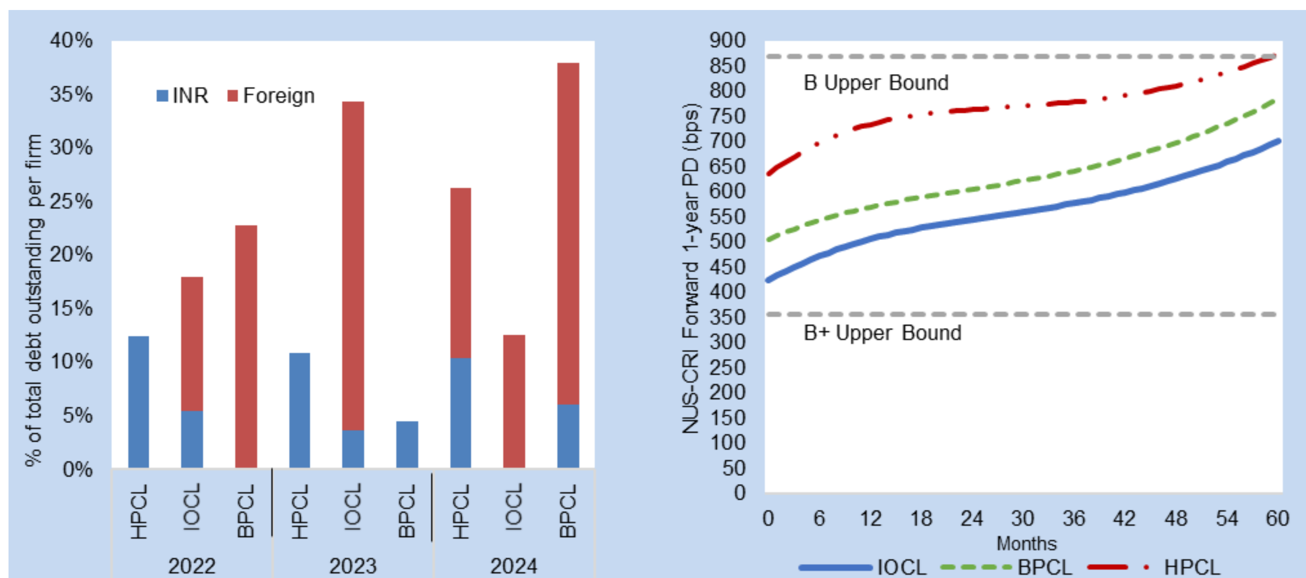

Figure 2a (LHS): Debt maturity breakdown by currencies for Indian Fuel Retailers from 2022 to 2024. Figure 2b: NUS-CRI Forward 1-year PD of Indian Oil Corp Ltd (IOCL), Bharat Petroleum Corp Ltd (BPCL), and Hindustan Petroleum Corp Ltd (HPCL) as of Mar-2022. *Source: NUS-CRI, Bloomberg*

The soaring cost of fuel also translates to a rapid increase in inflation in India, especially as the industry expects further price hikes in the short term to make up for losses. With headline inflation already in breach of the Reserve Bank of India's target range, rapid hikes in policy rates can be expected. Resultantly, the cost of debt for corporates may also see a concurrent rise and may imply a higher cost of refinancing in INR for Indian fuel retailers. In the context of rising costs and low margins, servicing of short-term liabilities may also be hindered further due to adverse impact on liquidity. The average interest coverage ratio for the three major fuel retailers has already decreased from 8.6x to 5.3x between Q3 and Q4 2021, with HPCL seeing a bigger decline from 13x to 3x. The NUS-CRI Forward 1-year PD (See Figure 2b) of the three major retailers as of Mar-2022 suggests that the outlook for HPCL is worse off as compared to its peers. The company witnessed a more significant contraction in profit margins in Dec-2021, dropping to 1.4% as compared to 2.9% for BPCL and 3.7% for IOCL. Consequently, HPCL's total debt/EBITDA also saw a sharp decline from 2.3x in Mar-2021 to 6.3x in Dec-2021. Simultaneous to the declines in profitability faced by the firms, they have also been tasked by the government to increase capital expenditure over the next 12 months as part of the government's plan to boost growth. As their cash flow generating abilities remain depressed, the firms will most likely have to fund the capital expenditure via debt, further adding stress to their credit profiles. Additionally, with the global crude oil price expected to push higher on the back of supply constraints driven by the Russia-Ukraine crisis, higher costs will continue to constrain the retailers' margins and prolong recovery.

Although retail fuel prices are decontrolled in India, they are heavily influenced by government intervention. A sharp increase in retail fuel prices would threaten the economic recovery and growth. With the government

already facing a backlash over initiating price hikes, it is currently evaluating strategies to reduce cost pass-through. Amongst proposals under consideration is a possible lowering of excise duty imposed on fuel and negotiating favorable terms with trade partners like the UAE. The government's reluctance in passing on the fuel price hike to consumers means that the burden of the price hike will be shared by the consumers, fuel retailers and the government. Hence, Indian fuel retailers will have to absorb a part of the loss and contend with depressed margins for a prolonged period. In addition, the price hikes will also fuel inflation in the country and may potentially reduce consumption which could serve as an added blow to Indian fuel retailers' margins.

Credit News

This is now the worst drawdown on record for global fixed income

Mar 23. The Bloomberg Global Aggregate Index fell by more than 11% since its peak in January surpassing the 10.8% drawdown during the 2008 financial crisis, as bond investors exit their positions in anticipation of tightening monetary policy. The rising global inflationary pressure and the hawkish stance of central banks to combat it diminish the attractiveness of bonds, whose valuation is highly sensitive to interest rates. This event challenges the notion that bonds are the safer investment that supposedly hedges against inflation. Meanwhile, considering that global equity markets still have not recovered from losses, investors are retreating from both fixed-income and stock markets altogether, upending the 60-40 portfolio model. (Bloomberg)

US companies forced to pay up to borrow through debt markets

Mar 22. Raising cash in the US has become more difficult as the IPO market is experiencing a downturn and companies are forced to borrow from debt markets due to the Federal Reserve's tightening monetary policy. The IPO market in the US has been slowed to a standstill as average stock prices fell more than 31% due to a huge sell-off from high market volatility. Meanwhile, the market is expecting an interest hike as the Fed is going to dampen excess demand by tightening financial conditions to tamp down rampant inflation. As a result, the US government bond yields, which is the risk-free benchmark for almost all financial markets, reached the highest level in nearly three years, increasing the borrowing costs for companies. Therefore, companies have begun to choose to avoid financing through the US debt market. (FT)

Junk bonds sold by energy companies boosted by oil surge

Mar 27. Junk-rated energy companies have shifted behaviors and have become more responsible in paying down debt. Some of these companies are expected to be upgraded from the current junk status to high-yield or investment grade in the future. The positive developments, coupled with the increasing oil prices, encouraged the active trading of these energy bonds. Moreover, because the credit standing of the energy companies is deemed to have improved, investors are willing to accept less compensation for holding the risk, widening the spread to around 12 percentage points more than the rest of the market. (FT)

Evergrande's hidden debt sinkhole just keeps growing

Mar 22. Evergrande has disclosed that more than USD 2bn of cash held by its separately listed property-service unit was seized by financial institutions as collateral for third-party pledge guarantees. This signals that domestic financial institutions are still trying to claim as many assets as possible from Evergrande, leaving an even smaller balance sheet for other creditors, especially offshore lenders and bondholders. Cash seized from Evergrande's property services unit, which was one of Evergrande's most lucrative assets, accounts for nearly all the cash held by the subsidiary. Another problem that is plaguing the industry is that of hidden debt, which is not just restricted to Evergrande. Regardless, it is not surprising that the Chinese real estate sector's debt woes are still around the corner. (WSJ)

Evergrande crisis locks Chinese developers out of global debt market

Mar 26. US dollar bond issuance by Chinese property developers has come to a near standstill as the Evergrande crisis has cut off other property firms' access to global capital markets. In 2022, High yield dollar bond issuance by Chinese developers has fallen by a record 97% compared to the first period of last year. Meanwhile, the cost of borrowing for developers from international markets has jumped to an all-time high. For example, the average yield on Chinese high-yield bonds has reached 32.9% in March, compared with a previous high of nearly 32% in 2008, showing international investors' lack of confidence in China's property market. Concerns over a lack of disclosure for China's property companies have been spurred due to Evergrande's default as it is difficult for international investors to assess the company's hidden debts. (FT)

Sunac China seeks two-year extension on USD 627mn bond (Nikkei)

Flattening yield curve stirs recession debate (WSJ)

Five ways Muni investors can navigate a rising-rate environment (WSJ)

Regulatory Updates

ECB to tighten banks' access to cheap funding

Mar 24. Amidst rising inflation and further economic pressures expected from the Ukraine war, the ECB will be gradually phasing out the remaining collateral easing measures it had adopted back in 2020. This signifies that the ECB deems that the financial system has recovered satisfactorily and is robust enough to weather any future stress. At the same time, the move signals the ECB's direction towards tightening monetary policy to address the rising inflation by ensuring that the economy has generally returned to normal, which means that any funding that is deemed as too cheap should be regularized. The phase-out will begin in July by increasing collateral valuation haircuts and will extend until 2024, especially for Greek government bonds that are being used as collateral (FT)

Bond markets in historic downturn as central banks battle inflation

Mar 24. Central banks are determined to control the highest inflation in decades by tightening monetary policy. The Fed has taken an aggressive stance, raised rates for the first time since the 2008 financial crisis, and hinted at further rate adjustments if necessary. At the same time, the BOE has raised interest rates for a third consecutive time and is expected to increase short-term borrowing costs by end of the year. Even the ECB had accelerated the wrapping up of its bond-buying program and is poised to impose tightening measures. As a result, global bond markets are feeling the impact, especially shorter-term bonds whose yields are highly sensitive to changes in interest rates. Long-term yields have also increased as a result of rising inflation expectations. Moreover, as corporate debt suffers sharper losses, credit spreads are consequently widening. (FT)

Interest rate rise threatens Australia's booming housing market (FT)

Central banks unlikely to offer immediate support to energy markets (FT)

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