Weekly Credit Brief
Nov 01 - Nov 07 2022

Legoland's developer's default contagion elevates credit risk of Korean companies on liquidity fears

by NUS-CRI Market Monitoring Team

- **NUS-CRI Agg PD of Korean companies increases as the default of a Korean developer precipitated a selloff in the domestic bond market, resulting in a liquidity crunch**
- **NUS-CRI Agg Forward PD indicates that rising borrowing costs and slowing corporate revenue growth could contribute to an elevated credit risk outlook**

South Korea domiciled companies (Korean companies) are feeling the brunt of macroeconomic woes leading to fears of a possible recession, stemming from high inflation, a weaker KRW against the USD and a tighter monetary policy with the Bank of Korea (BOK) raising rates to 3%, its highest level since 2012. As lending rates continue to climb, the KOSPI has fallen by approximately 20% year-to-date. Recently, adding fuel to the fire, South Korea's debt market was thrown into turmoil after a government-backed developer of Legoland missed a bond payment in Sep-2022, raising concerns regarding the robustness of Korean companies' financial health.

Following its default, South Korean credit markets experienced one of the worst performances in Asia as yields on investment-grade corporate debt jumped to 157bps, the worst on record. As seen from the NUS-CRI 1-year Aggregate (median) Probability of Default (Agg PD) of Korean companies over the past few months in Figure 1a, the aggregate credit risk of Korean companies has been steadily increasing and now stands above the BBB+ upper bound, when referenced to PDiR2.0[1], reaching levels last seen during the initial onset of the pandemic in Mar-2020. Although the South Korean government has rapidly announced a slew of measures to support credit markets, the attempt has yet to boost investor confidence as markets remain volatile and liquidity remains scarce. Lackluster economic data and increasing household and corporate debt burdens continue to threaten corporate revenue growth keeping credit risk elevated, though still below non-investment grade level, as indicated by the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[2]) for Korean companies (See Figure 1b).

[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.
[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.

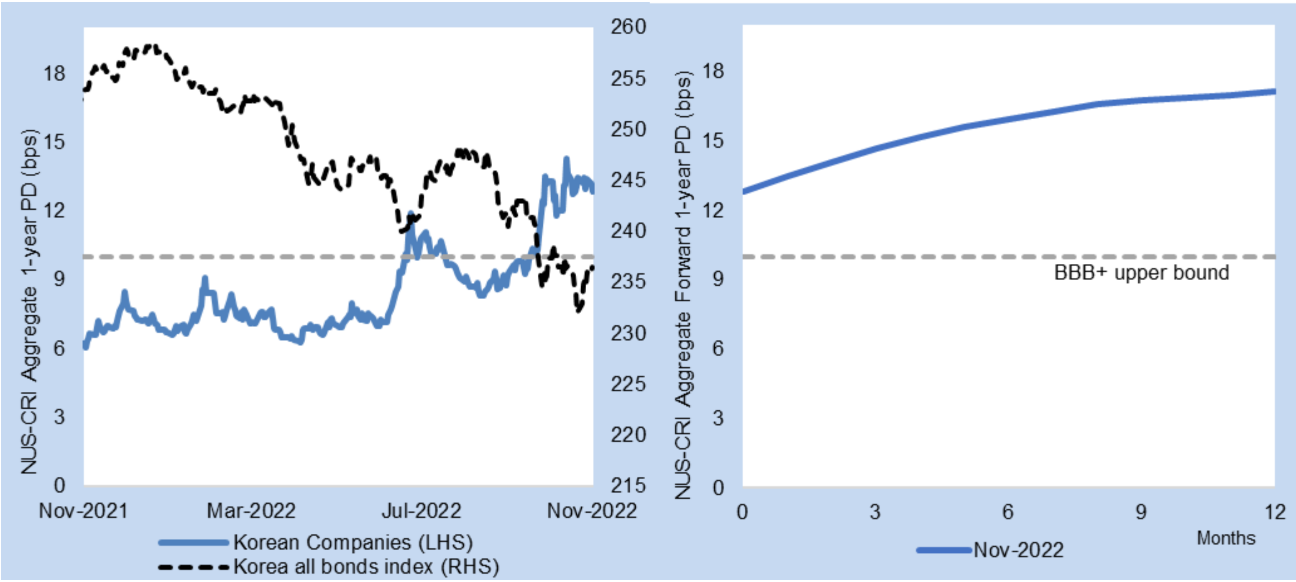

Figure 1a (LHS): NUS-CRI Aggregate (median) 1-year PD for South Korean companies, with reference to PDiR2.0 bounds; KAP Korea Bond Pricing All Bonds index[3]. Figure 1b (RHS): NUS-CRI Aggregate (median) Forward 1-year PD for South Korean companies as of Nov-2022, with reference to PDiR2.0 bounds. *Source: NUS-CRI, Bloomberg*

Notwithstanding the catalytic effect of the latest liquidity crunch felt in the credit markets, Korean companies have been battling multiple operating and financing headwinds since the beginning of this year. The BOK recently tweaked its economic growth estimates to reflect the slowest quarterly GDP growth in a year attributed to a slowdown in exports, which dropped in Oct-2022 for the first time in 24 months by 5.7% YoY. At a time when the KRW continues to weaken as the US continues its interest rate hikes, higher import costs continue to outweigh exports. The Fed's recent massive 75bps rate hike, and the resultant depreciation of the KRW, are expected to push up operating and raw material costs for most Korean companies, especially those in the semiconductors, automobile, and steel industries, whose profitability is likely to be muted in the near future contributing to the heightened credit risk outlook (see Figure 1b). South Korean semiconductor and automobile manufacturers find themselves in the middle of the US-China chip war which may affect their revenue-generating capabilities, especially since South Korea supplies 45% of China's memory chip demand through exports or via production in China-domiciled plants[4]. On a broader view, a slowdown in domestic production is also felt across various sectors as input costs surge, so much so that the South Korean Purchasing Managers' Index (PMI) remained sub-50 for the fourth consecutive month in Oct-2022. This worsening macroeconomic environment highlights the potential profitability-related challenges that Korean companies are going to face in the short-to-medium term.

The stress in Korean companies, as well as the wider sell-off in the Korean public markets, also elevates the credit risk of the country's banking sector (see Figure 2a). Amid global headwinds and corporate profitability woes, loans extended to Korean companies by major local banks saw a USD 6.18bn increase in Oct-2022, the highest in 13 months, as corporates resorted to bank loans due to bond market strains. While such credit facilities could temporarily bridge the liquidity needs of South Korean corporates and improve the banks' profitability in a tight monetary environment, a potential worsening in the underlying corporate credit conditions could increase the burden of banks' non-performing assets, potentially worsening their asset quality. This may prove to be true as lending rates by Korean banks have steadily been increasing since last year (See Figure 2b), and as floating-rate loans account for around 70% of credit extended by the banking sector, the BOK projects that 18.6% of Korean companies may see their interest costs exceed operating profit, up from 14.9% at the beginning of this year, potentially burdening asset quality of Korean banks moving forward.

[3] The KAP Korea Bond Pricing All Bonds index comprises of domestic South Korean bonds which have a rating of BBB- or higher. Base value: 100 points as of Jan-2001.

[4] Samsung Electronics and SK Hynix, semiconductor companies with a major production footprint in China, are among the companies subject to US chips equipment export controls under the US CHIPS Act. They were granted a 1-year waiver to use equipment containing American technology in China.

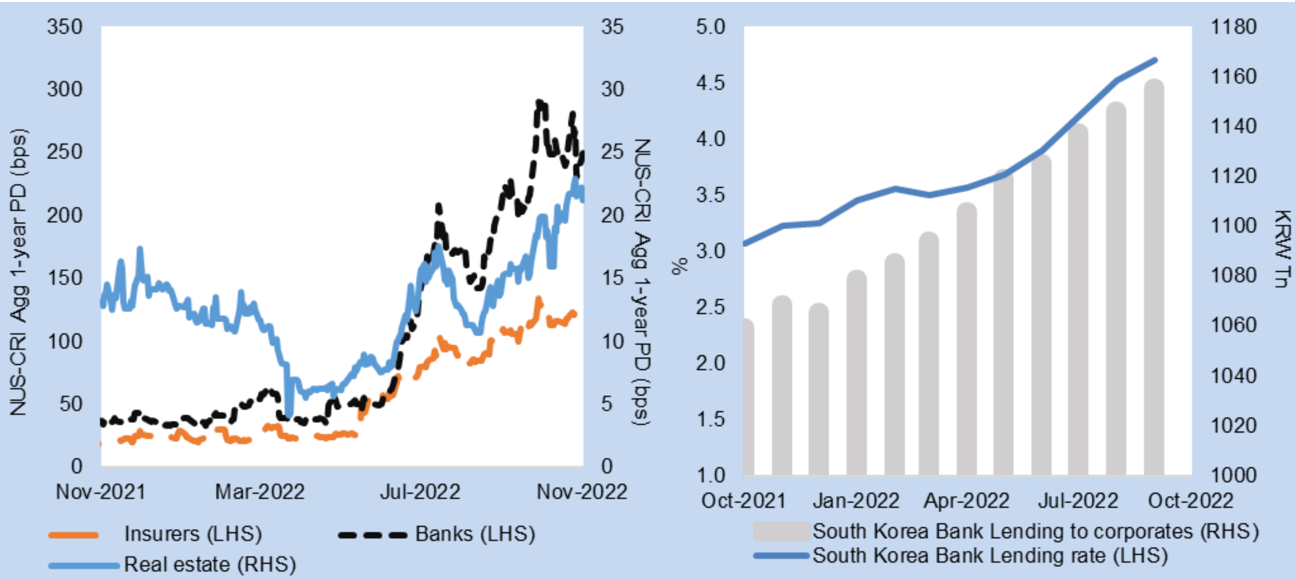

Figure 2a (LHS): NUS-CRI Aggregate (median) 1-year PD for South Korean insurance, banking and real estate sectors. Figure 2b (RHS): South Korea Bank Lending rate; South Korea Bank lending to corporates - total balance (as of month end). *Source: NUS-CRI, Trading economics, Bloomberg*

Furthermore, with Sep-2022 registering the biggest decline in house prices for the country since the global financial crisis of 2009, the credit quality of Korea's real estate sector is already witnessing the effects of a downturn in the housing market amidst rising borrowing costs and its resultant demand slowdown (see Figure 2a). The above-mentioned default of Legoland's developer, which triggered the current liquidity crunch, highlights the effect of the real estate sector's potentially weakened credit health[5]. The sector is also facing a profit squeeze as an increase in mortgage costs signals a demand slowdown in the sector, with the volume of retail and commercial property transactions already falling by 21% MoM in Aug-2022. Concurrently, the Agg PD of the Korean real estate sector in Figure 2a increases by close to 20bps since Mar-2022. The BOK is expected to undertake another 50 bps hike in November, with the mortgage rate being pushed as high as 9%, burdening an already indebted household sector and potentially suppressing housing demand further.

In the face of brewing trouble in the real estate sector amid rising interest rates, its potential impact on the insurance sector also comes into the foreground (see Figure 2a). Korean insurance firms have been increasingly investing in Project Finance Asset-Backed commercial papers (PF-ABCP), with overall exposure to the real estate industry reaching KRW 42tn, the highest amongst financial firms. Should the financial health of the real estate sector continue to worsen further, the contagion effect might worsen the asset quality of these PF-ABCPs held by insurers. Additionally, with Korean insurers required to meet higher regulatory standards at the beginning of 2023 by strengthening their capital positions, the recent turmoil in Korean money markets has hampered insurers' ability to raise cheap funds from the public markets[6] and potentially added a strain on their capital buffers. The insurance sector may now have to contend with lower demand for new bond issuances and higher financing costs as it tries to raise capital to meet regulatory standards.

Korean policymakers have acted swiftly to stabilize markets and curb the widespread turmoil that roiled the domestic credit markets. The government announced measures expanding liquidity to about USD 35bn to ease liquidity concerns. A consortium of five financial holding companies, on the request of the regulator, pledged to improve liquidity in the markets by KRW 95tn by the end of this year. Although the measures announced may alleviate credit pressures in the short term, the recent distress in the Korean credit markets highlights the wider fragility present in the Asian markets, stemming from the market fearing a similar crisis as that currently being faced by China.

[5] South Korea's real estate sector has close to USD 16.6bn worth of commercial paper set to mature by the end of 2022, which is adding to concerns by investors regarding the liquidity available in the wider South Korean market, raising refinancing costs.

[6] Due to market conditions, South Korean Insurer Heungkuk Life Insurance Co decided to not exercise its call option to buy back its bonds for the first time since 2009, which lowered investor confidence regarding the financial health of the company and the wider market. This event also triggered a market rout which saw a sell-off in perpetual bonds of major financial institutions across Asia.

Credit News

Billions in capital calls threaten to wreak havoc on global stocks, bonds

Nov 07. With financial conditions tightening globally, numerous private-market funds now face capital calls. Though larger institutional investors are expected to be liquid enough to meet the capital call requirements, it is estimated that a lot of other investors will be forced to liquidate their positions in global markets to raise the required cash, which may result in further losses in public markets. Out of major fund categories, it seems that buyout firms have the largest net negative commitments, signifying that for these funds investors had to cough up more money than the returns they made. (Bloomberg)

A mark-to-market massacre is claiming a USD 10tn market

Nov 02. Bond prices are at the risk of further declining due to rising interest rates, especially as rates are projected to increase to the tune of the Fed's renewed commitment to hike rates up to a sufficiently restrictive level. Such a decline in debt value due to embedded duration risk is likely to extend across various debt qualities. This hurts investors' sentiment in the USD 10tn credit market who expected bonds to be safe investments in a volatile market. Moreover, there is a growing concern that the decline in bond prices also indicates a possible increase in credit risk. (Bloomberg)

China property bonds are 'no longer analyzable' as crisis grows

Nov 03. The market value of IG China real-estate dollar bonds has dropped 23% over the past month, 16 percentage points more than the drop seen on the USD-denominated Chinese IG bond index. The continued worsening market conditions for the real estate sector are shifting analysts' focus from fundamental analysis to market-based. The shift has also accelerated due to the large number of defaults witnessed in the market. On the back of the turmoil, analysts have lost confidence in the sector, quoting "such prices are certainly not justified for any normal market, but they are justified for a black box market which is beyond analysis". (Bloomberg)

Sterling debt still bears Truss scars after best month since 2009

Nov 01. Following the end of Liz Truss' tenor and Rishi Sunak's takeover, high-grade sterling company debts have yields falling by over 73 bps in October, the best performance since Aug-2009. It remains uncertain if the rally can be sustained as the Bank of England (BoE) has started selling debt just as the government prepares further plans for more borrowing this month. Investors remain cautious about sterling credit with sentiments that while it can trade tighter it is unlikely to outperform credit in other currencies. (Bloomberg)

Korea credit crisis spreads as bond uncalled in first since 2009

Nov 02. Heungkuk Life Insurance Co., a South Korean insurer, took an unconventional step of delaying the exercise of a call option on its perpetual bond sparking a selloff in the local credit market. Since the past quarter, South Korea has been struggling to control the deterioration of its domestic credit market, which experienced one of the worst bond market routs in Asia. Yields on local commercial paper that companies use to meet short-term obligations jumped to a 13-year high and spreads on won-denominated corporate bonds have soared to levels last seen in 2010. (Bloomberg)

JPMorgan's Michele sees high-grade debt as 'anchor in the storm' (Bloomberg)

Indian companies withdraw long-tenor bonds as investors seek higher rates (Reuters)

Cash-starved Turkey firms pushed to lira debt despite 36% yields (Bloomberg)

Regulatory Updates

BoE raises key interest rate by 0.75 point

Nov 03. BoE hiked the key interest rate by 75 percentage points – its largest increase since 1989. By the bank's estimate, the move to lift rates from 2.25% to 3% alongside sky-high inflation is likely to drive the economy into a yearlong recession. Following the announcement, the pound weakened against the dollar while UK government bonds faced a sell-off with yields rising to 3.515%. However, the bank signaled that it is not expecting to raise rates as much as the market expects. (WSJ)

SEC proposes mutual fund-pricing rule to protect long-term investors

Nov 03. The SEC is proposing the adoption of a swing pricing mechanism that aims to shift the cost of rapid fund movements or volatile trading sessions to redeeming shareholders rather than the remaining shareholders, especially during periods of stress. Under this pricing scheme, fund managers would be required to include the additional costs in the daily net asset values, similar to what is being implemented for European funds. The proposal stemmed from the liquidity squeeze faced by open-end funds in Mar-2020 due to pandemic-induced redemptions. In addition, the SEC is also proposing that mutual funds maintain highly liquid securities equivalent to at least 10% of their assets. (FT)

EU regulators warn Brussels on dilution of global banking rules (FT)

Japan to issue extra new bonds for stimulus, straining debt (The Straits Times)

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