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Weekly Credit Brief Nov 02 - Nov 08 2021

Credit profile for China's coal industry remains stable despite supply-side challenges

by Valerie Kok & Amrita Parab

- **Despite rapid increases in supply and falling prices threatening profits, the credit outlook of China's largely state-owned coal industry remains stable due to state intervention and stable underlying financial health**
- **The NUS-CRI Agg (median) Forward 1-year PD demonstrates that the credit risk of China's coal industry is likely to remain stable on the back of continued access to financing and strong demand for coal**

In a bid to ease the recent energy crisis seen in China's coal market, the Chinese government has taken aggressive measures to tackle domestic coal shortage and the resultant skyrocketing coal prices. At the height of the energy crisis in September, authorities ordered more than 150 mines to expand production, while pressuring companies to lower coal prices[1]. Yet, despite rapid capacity expansions and falling prices threatening profits, China's domestic coal industry has continued to remain stable against external shocks, as depicted by the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) in Figure 1b. The Agg PD has remained stable, fluctuating around the BB+ upper bound since 2018, two years after the implementation of supply-side reforms. It owes largely to the country's sustained dependence on coal and state intervention facilitating adequate access to financing, as well as stable financial health. Moving forward, with the government likely to continue providing easier access to financing channels for the industry, the NUS-CRI Agg (median) Forward 1-year PD[2] demonstrates that the credit outlook remains stable (See Figure 2a).

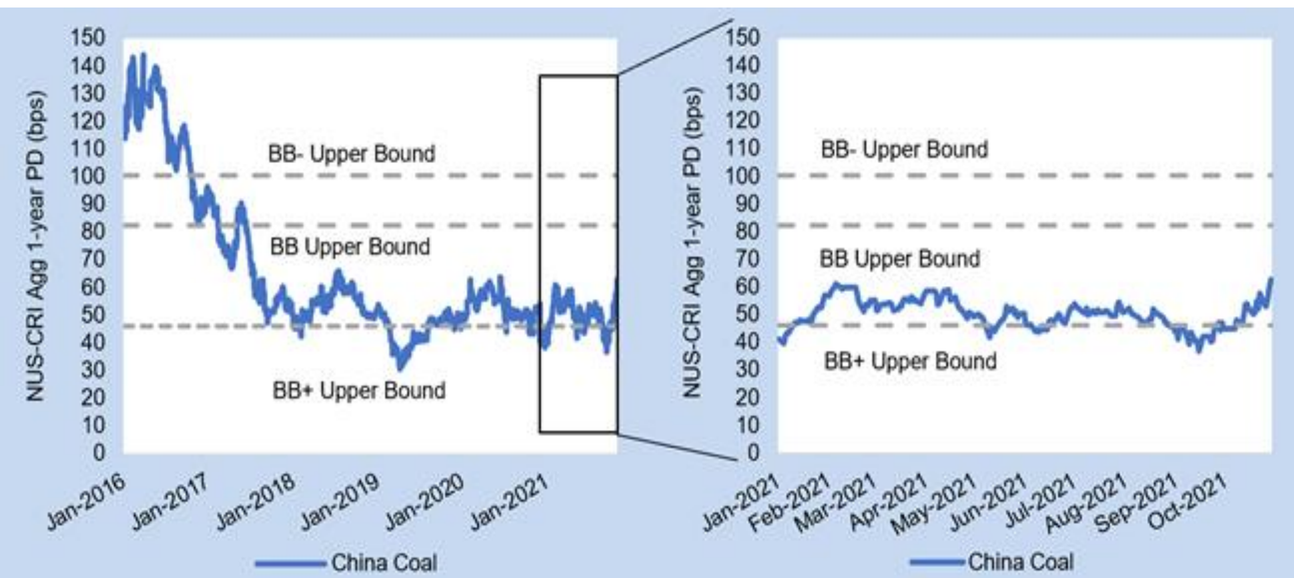

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for China's coal industry from Jan-2016 to Oct-2021 with reference to PDiR2.0[3] bounds.
Figure 1b (RHS): NUS-CRI Agg (median) 1-year PD for China's coal industry from Jan-2021 to Oct-2021 with reference to PDiR2.0 bounds.
Source: NUS-CRI

As seen in Figure 1a, the Agg PD demonstrates the improving credit risk profile of the industry from 2016 to 2018. At the beginning of 2016, a serious glut in capacity, coupled with declining demand for coal decreased coal prices and profitability, pushing the credit risk of the Chinese coal sector into a 10-year high. However,

[1] As of early November, coal producers in the three key coal-producing regions, Shanxi, Shaanxi and Inner Mongolia, have all pledged to cut prices, and more than 10 large coal companies have reduced prices.
[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.

benefiting from the supply-side reforms and an influx of infrastructure projects from the local governments since 2016 that boosted consumption and coal prices, the coal industry took two years to improve their credit profiles, concurrently benefiting from improved profitability (See Figure 2b). From 2018 onwards, the Agg PD of the industry stabilized as overcapacity no longer became a concern, and demand remained robust. Despite the macroeconomic volatility witnessed in the coal industry over the past few years, the financial health of Chinese coal producers has been relatively stable, as seen in Figure 2b, with the debt-to-capital ratio fluctuating around 40%, and the current ratio hovering around 1.0.

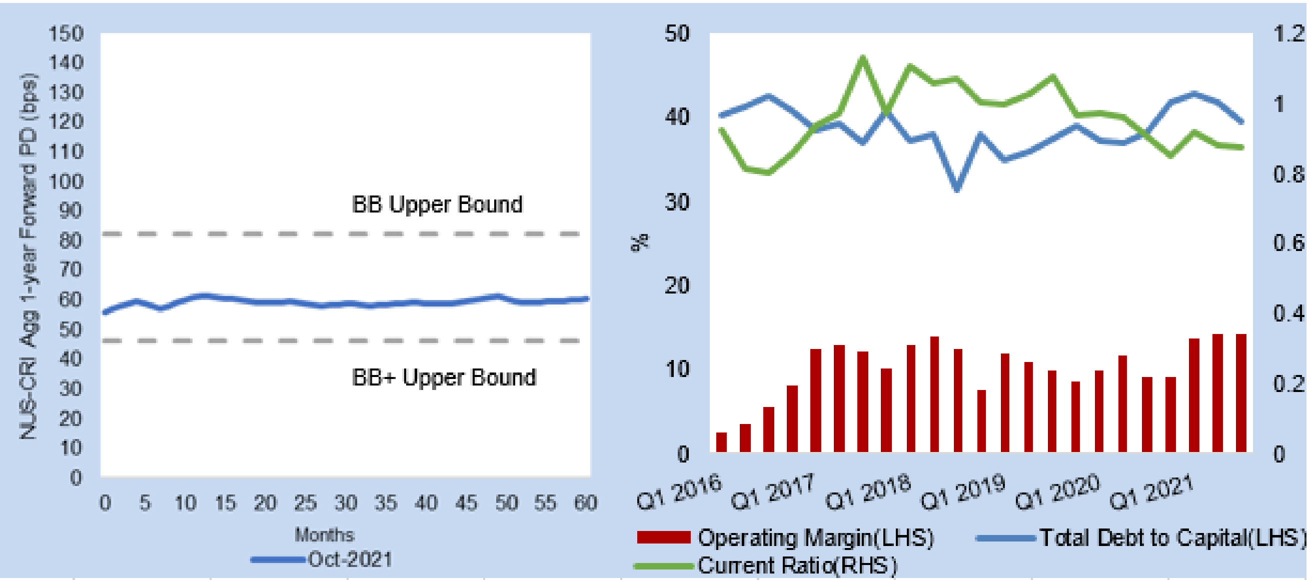

Figure 2a (LHS): NUS-CRI Agg (Median) Forward 1-year PD for China's coal industry as of Oct-2021 with reference to PDiR2.0 bounds. Figure 2b (RHS): Total Debt to Capital (LHS), Operating Margin (LHS), and Current Ratio (RHS) for China's coal industry from Q1 2016 to Q3 2021. *Source: NUS-CRI, Bloomberg*

More recently, a demand surge driven by post-pandemic recovery coupled with the government's emission reduction campaign resulted in a massive shortage in coal supply. Additionally, the unofficial ban on Australian coal imports, which as of 2019 constituted 38% of China's thermal coal imports, combined with floods in key mining regions in mid-October further exacerbated the shortage. With coal inventories down 30% YoY, concerns about the ability of the coal industry to cope with the demand surge pushed prices higher. Since Jan-2021, thermal coal prices have soared from about CNY 670/ton to around CNY 1,100/ton in September, where the shortage was at its peak. In light of these recent shortages, capacity expansions at hundreds of coal mines were approved to support the production of an additional 100mn tons of fuel in Q4 2021. According to the National Development and Reform Commission (NDRC), average daily coal production has risen above 11.5mn tons since mid-October, up by 1.1mn tons from the end of September. At the same time, there are plans to cap coal prices at CNY 440/ton until at least May-2022, hindering the industry's profit-generating capabilities and which may have led to a concurrent increase in the Agg PD (See Figure 1b).

Despite supply-side challenges, Chinese coal companies could continue to take advantage of adequate access to financing. In September, regulators called on financial institutions to increase their risk tolerance for loans to the coal industry, prohibited banks from withdrawing loans to coal producers that were in compliance with their lending criteria, and warned against speculation on coal prices. Furthermore, in mid-October, the People's Bank of China urged lenders to provide sufficient support to the coal industry, which could bolster liquidity for the industry should macroeconomic conditions worsen. These factors have contributed to the relative stability of the coal industry's credit quality since the start of this year despite the recent supply-side challenges.

Looking forward, it is likely that the central and local governments in China will continue to support the domestic coal industry in the short term, given that China's dependency on coal still accounts for 57% of China's domestic energy generation. China's coal consumption has been predicted to increase by 6% by the end of 2021 compared to last year. Should the industry continue to face exogenous supply shocks, the Chinese government is likely to continue easy access to financing channels to protect the industry's operational viability. In the longer term, despite the move towards cleaner energy, China plans to keep increasing coal production until 2025. With President Xi Jinping's absence at the COP26 talks and a lack of strong commitment to reducing domestic coal usage, China may continue to sustain domestic coal production to ensure stable energy supplies over the next few years. Additionally, concerns regarding employment and social stability make the transition away from coal much more difficult. Concurrent with these developments, the Agg Forward PD also demonstrates a stable outlook both in the short and the long term.

Credit News

China bond market meltdown brings world of hidden bills to light

Nov 5. China's real estate meltdown has revealed off-balance-sheet obligations that developers were unaware of. News of missed payment on off-balance-sheet obligations such as HY consumer products, undisclosed loans, and bond guarantees have fueled the meltdown in recent weeks. Investors are left scrambling to re-assess their risk exposure and loss severity in the event of default. The worsening investor sentiment has led an index tracking developers to plunge to its lowest level since Mar 2017 and has caused HY dollar bond yields to climb to 22%, thus, limiting the refinancing options available to firms. Other capital raising avenues are drying up fast as plunging home sales limit revenue, and asset disposals become difficult. (Bloomberg)

Bond markets flash turmoil, and no one else much cares

Nov 4. Investors have shaken the government bond market in the past month while other markets appear unconcerned. This week, Fed Chairman Powell confirmed that quantitative-easing program would be tapered, prompting investors to reassess government bonds. There are several explanations for why other markets are indifferent to fluctuations in bond yields, and the simplest is that the recent moves were primarily technical. A bearish explanation is that the huge infusion of money into the economy by governments and central banks has numbed investors. Volatility outbreaks in certain assets do not spread due to ample liquidity in other markets that damp down any swings. The bullish interpretation is that bond moves only reflect the expectations that rate hikes by central banks aim to keep up with inflation, instead of impeding the economy. (WSJ)

Chinese developer Kaisa suspends shares as liquidity problems spread

Nov 5. Kaisa Group Holdings' shares were suspended on Friday, a day after the troubled business added to China's real estate sector's increasing liquidity crisis by announcing that wealth management products it backed had missed interest payments. The company's problems reflect the escalation of a crisis in China's highly indebted real estate sector. Companies have been pressured by Beijing to decrease their leverage, but are now facing growing liquidity concerns that have led to multiple defaults. As developers' debts mature, rising borrowing costs make refinancing prohibitively expensive. Kaisa, the first of the country's developers to default overseas in 2015 and undergo a restructuring, is one of the sector's major borrowers on international markets, with over USD 3bn due in the following year. (FT)

Chinese banks quicken home loan disbursement but caution prevails

Nov 5. Some Chinese banks have quickened the disbursement of home loans, but remain cautious in issuing new loans due to government regulations to deleverage the property sector. Banks granted close to an additional USD 31bn in property loans in October compared to the previous month. The approval time for mortgage loans has also shortened due to weaker demand, with new home prices in major cities barely growing in October. Additionally, after a two-month halt, banks' issuances of residential mortgage-backed securities have also increased to CNY 77bn in September. This indicates that banks are raising capital as they use up their funds to lend to homebuyers. (CNA)

China's developer bond slump deepens as selling spreads onshore

Nov 4. Sell-off in Chinese property bonds escalated on Thursday, with yields on HY dollar debt climbing to 21%. China's real estate developers face a difficult predicament as high borrowing costs make refinancing upcoming maturities difficult, leading to further losses as traders price in possible haircuts. A slowdown in property sales and caps on leverage has added to the challenges faced by the developers. China's real estate developers are being downgraded by credit rating agencies at the fastest pace on record. The offshore bonds of developers have thus far escaped the meltdown, supported by the government's stance of limiting the contagion stemming from the real estate crisis. (Bloomberg)

China bonds advance on PBOC's USD 16bn liquidity injection (Bloomberg)

Evergrande contagion fears ripple through Asia's primary market (Bloomberg)

Bolsonaro plan to breach spending cap costs Brazil in bond market (Bloomberg)

Regulatory Updates

U.K. rate-decision surprise ripples across global bond markets

Nov 4. The Bank of England's decision not to hike interest rates caused one of the largest swings in UK bond yields in years. One-year government bond yields virtually halved in a matter of hours, falling 0.22 percentage point, the largest intraday shift since the financial crisis of 2009. The pound fell 1.4% against the dollar to USD 1.349/GBP, its steepest one-day drop in more than a year. The decline in the yield spread to other government bond markets. The yield on two-year Treasury notes in the United States fell 0.07 percentage points to 0.41%. The market's surprise highlights the difficulty investors are having reading central bank signals about how swiftly they intend to combat inflation, which has been increasing around the world due to a combination of rapid growth and global supply chain bottlenecks (WSJ)

US loan market begins shift away from tarnished Libor benchmark

Nov 4. Libor is in the process of being phased out as a benchmark rate by companies borrowing in the US credit market. A few firms have now borrowed money using Sofr, a widely acknowledged substitute for Libor. After Libor's reputation was tarnished, the adoption of Sofr computed based on market transactions, is a key step toward creating a new benchmark rate. Regulators have ordered that no new deals should be pegged to Libor from 2022 onwards, phasing out the benchmark by the end of June 2023. The transition in the loan market, however, has been slow, partly because there is no first-mover advantage in moving away from Libor. Negotiations are still underway to determine new conventions for pricing deals tied to Sofr. The fact that Libor is higher than Sofr has complicated the process, forcing the interest rate on transactions to be adjusted so that borrowing costs are equal for companies using both types of benchmark rates. (FT)

Central bankers plot course through end of easy money minefield (Bloomberg)

Bank of England to set out greener corporate bond plan – Bailey (Reuters)

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