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Indonesia's coal industry recovery may be temporary as risk remains

by Luo Weixiao

Indonesia's coal industry, once seen as one of the most lucrative industries in the country, is currently facing multiple headwinds. As one of the world's largest producers and exporters of coal, Indonesia exported USD 12.6bn worth of coal from Jan 2019 to Aug 2019, accounting for 20% of the country's total exports. In addition to the favorable geographical position, Indonesian coal's relatively competitive price on the international market due to adequate medium and low-quality thermal coal reserves and low labor cost makes the country a critical coal supplier for Asian countries. Seen as one of the most profitable businesses when coal price was comfortably high, the coal industry is facing a deteriorating credit profile in recent years. The falling coal price, weakening demand from its main destinations and funding pressure has weighed on the sector's credit profile.

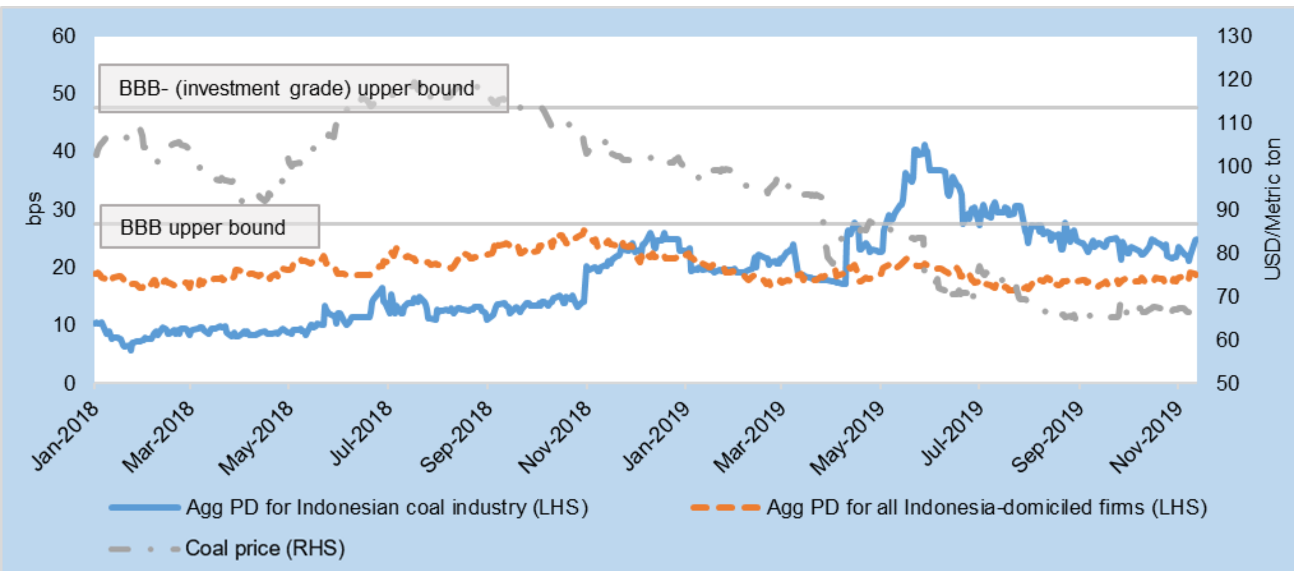

Figure 1: NUS-CRI Aggregate 1-year PD for Indonesian coal industry and for all Indonesia-domiciled firms; Generic 1st 'XW' Future price settled against the global COAL monthly NEWC index. *Source: NUS-CRI; Bloomberg*

The Indonesian coal industry was traditionally safer than most other industries in Indonesia as indicated by the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) of the companies (Figure 1). The Agg PD of the 27 publicly listed Indonesia-domiciled coal companies had stayed well below the aggregate level of all industries till the end of 2018 when coal price fluctuated within an acceptable range. However, when the coal price started to slump sharply in 2019, the Agg PD of the coal industry increased accordingly and surpassed that of the economy. In May 2019 when Agg PD of the coal industry was at its highest point, the sector entered the BBB- rating group (according to the NUS-CRI PDiR[1]), the lowest investment-grade rated group. While the Agg PD eventually decreased, it is still higher compared to the level seen earlier this year.

Coal price is the main factor causing the deteriorating credit profile. Coal price on the international market, tracked by Generic 1st 'XW' Future price settled against the global COAL monthly NEWC index, has tumbled about 30% this year and Harga Batubara Acuan (HBA), the Indonesian benchmark thermal coal price set by the

[1] The NUS-CRI Probability of Default Implied Rating (PDiR) provides a more conventional interpretation of PDs – it translates NUS-CRI 1-year PDs to letter ratings by taking reference from the historical observed default rates of S&P's rating categories.

government, has reached lowest point in Oct this year since 2016. The decreasing price has made companies difficult to generate free cash flow through the capital intensive mining projects and has pressured the sector's bottom line. The impact of pricing constraint has been shown in the coal industry's median net income- it has tumbled from USD 20.4 mn in Q1 2018 to USD 3.1mn in Q3 2019.

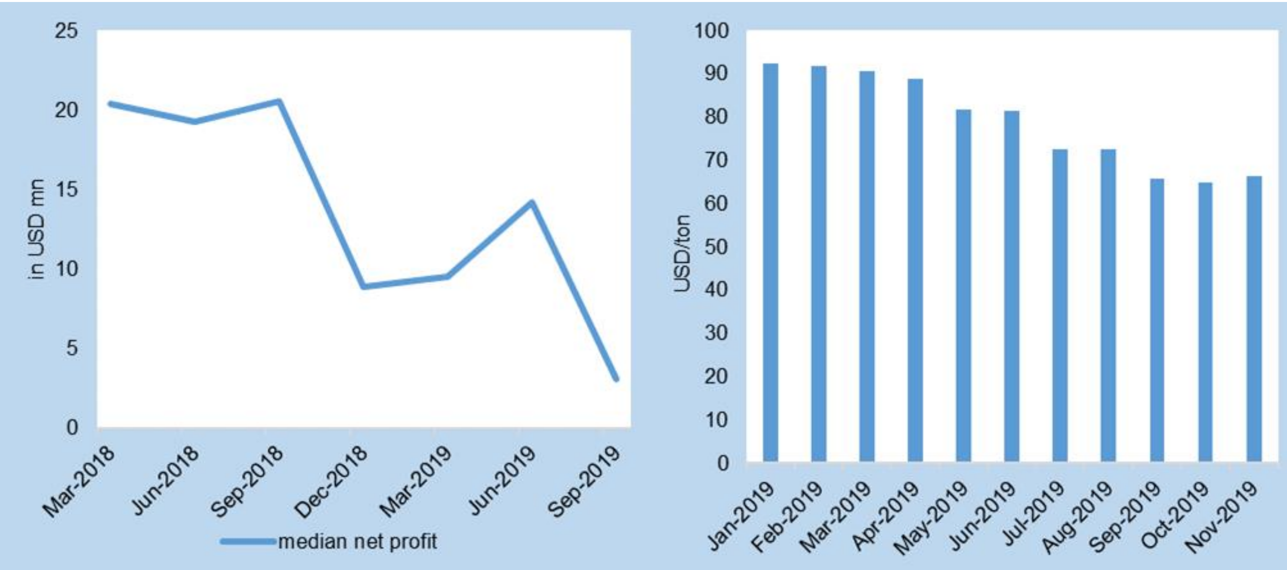

Figure 2a&2b: Median net income of Indonesian coal companies (LHS); Indonesian benchmark thermal coal price (RHS). *Source: Bloomberg*

The industry has also experienced a falling demand from its key importers. Indonesian coal exports are shipped mainly to Asian countries including India, China, Japan and Korea. The top four destinations import more than 60% of the total Indonesian coal exports every year and the Indonesian coal industry has been overly-dependent on the countries. The key destinations, especially India and China, delivered large buying interest to meet demand from their infrastructure projects in the 2000s when they experienced dramatic economic development. However, with the slowdown of the two countries and the change of China's energy policy, the Indonesian coal companies have been struggling to diversify their destinations and to keep coal exports at the previous level. China's government has announced that its 2019 coal import will be capped at the 2018 level this year to support domestic miners and customs clearance for arriving coal was halted at two Chinese ports this July. Though China didn't ban coal imports totally, the recent restrictions and the country's booming renewable projects urge the Indonesian coal industry to diversify its portfolio and look for alternative buyers.

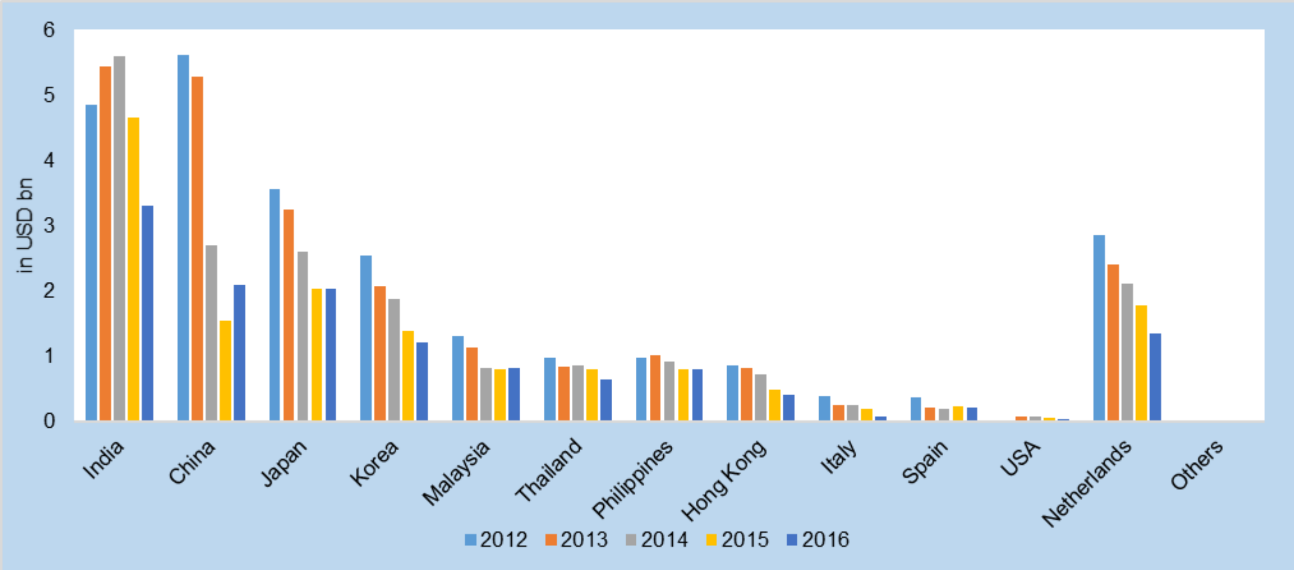

Figure 3: Indonesian coal export value by destinations. *Source: UN Comtrade*

While the miners enjoy cheaper offshore financing during the good time - to avoid the high-interest rate in Indonesia, they are facing heightened repayment pressure because of the depreciation of Rupiah and the difficulty of refinancing. The falling value of the local currency ballooned coal companies' foreign debts. Some big lenders have committed to stop financing either new thermal coal mines or coal-fired power plants, in a bid to expedite the transformation from coal to renewables. The industry now is facing USD 1,227bn foreign debts outstanding, which is 29.3% of total outstanding debts, and the worsening credit profile has also been manifested in the bond market. For example, the yield-to-maturity (YTM) for USD bonds issued by ABM Investama and Bumi resources, two leading Indonesian coal miners capturing a quarter of total market capitalization of the industry, has gone up since May 2019 as shown in Figure 4 below. YTM for the bond issued by ABM Investama went up and the spread to Indonesian Government USD Bond with the same maturity has widened to 11.28% in Nov 2019 from 3.24% in Jan 2018. Meanwhile, YTM for Bumi resources bond hit the highest level since inception, standing at 16.70% in mid-Nov 2019.

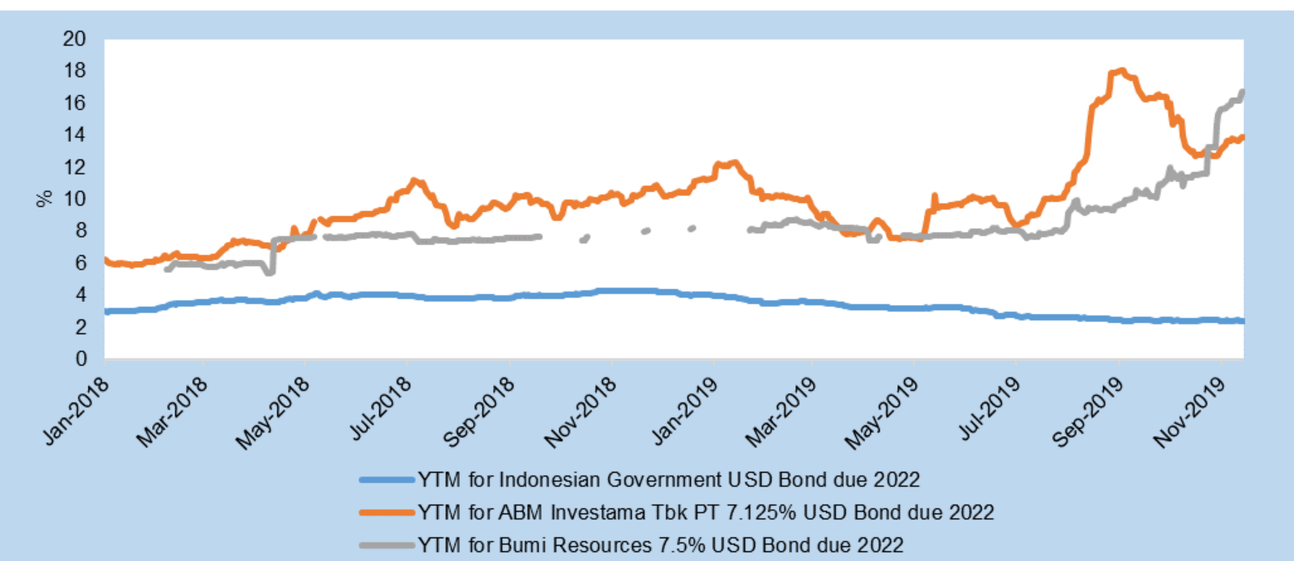

Figure 4: Yield-to-maturity of a selection of USD bonds issued by Indonesian coal companies; Yield-to-maturity of Indonesian Government USD bond. *Source: Bloomberg*

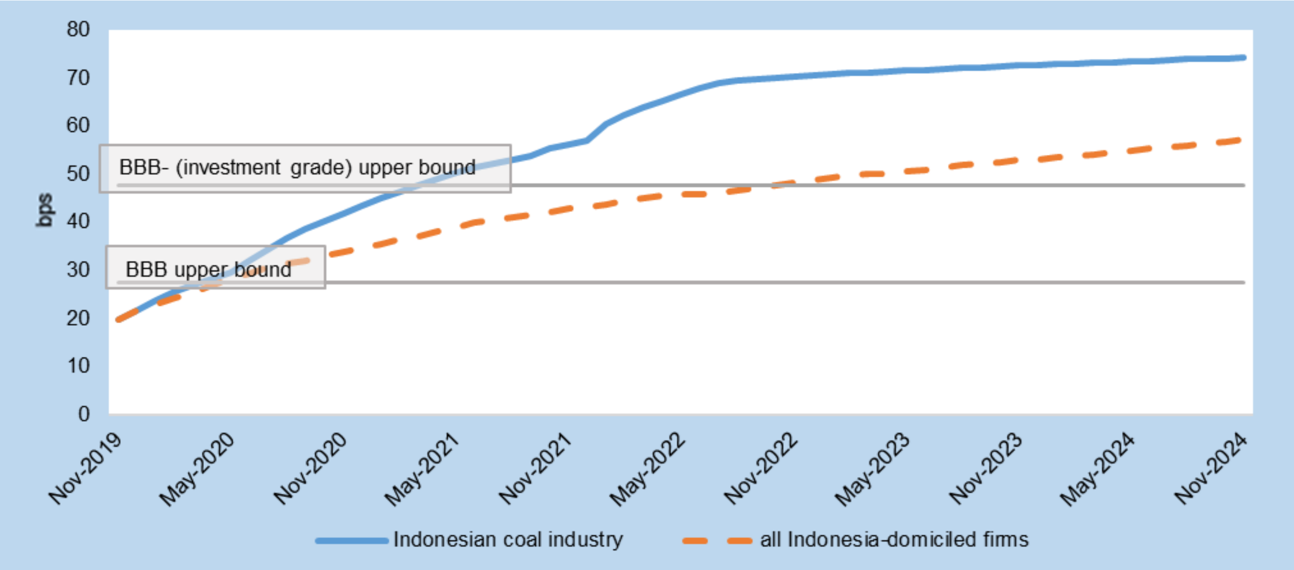

Figure 5: NUS-CRI Forward 1-year PD term structure of the Indonesian coal industry and all Indonesia-domiciled firms based on information on Nov 2019. *Source: NUS-CRI*

If the current market situation persists, the credit profile for Indonesian coal industry will continue to deteriorate as indicated in the NUS-CRI Aggregate (median) Forward 1-year PD[2], which reflects the credit risk of a sector in the future period at an aggregate level. While the Forward PD curves for both coal industry and all industries in Indonesia show an upward trend in the forecast period, the curves start to converge from six months from now and with all of the abovementioned pressures, the coal industry will enter the junk territory again in 18 months.

Credit News
PizzaExpress owner keeps lenders waiting for debt talks **Nov 16.** Bondholders of troubled restaurant company PizzaExpress Ltd, holding 70% of its most senior bonds, have attempted to communicate with the firm last week to supply new capital. However, Hony Capital, the Chinese firm which bought PizzaExpress in a USD 1.2bn leveraged buyout 5 years ago, has so far met the approach in silence. Since 2016, PizzaExpress's 8.625% unsecured bonds' price has dropped to 25 pence on the pound. Unsecured bondholders are planning to raise capital to buy out PizzaExpress's senior bonds and write them off. In exchange, Hony capital would give up control of the company and write down a GBP500m shareholder loan. (Bloomberg)
Global debt surged to a record USD 250tn in the first half of 2019, led by the US and China **Nov 15.** According to a report by the International Institute of Finance (IIF), global debt levels increased by USD 7.5tn in the first 6 months of 2019, causing the total number to hit a record high of more than USD 250tn. The occurrence was mainly driven by a surge in borrowings in the US and China, accounting for over 60% of the increase. Emerging market debt had also hit a new record of USD 71.4tn (220% of GDP), and global debt is forecasted to surpass USD 255tn this year. Economists have flagged the phenomenon of rising global debt as the next breaking point – where record-low interest rates make it extremely easy for corporates and sovereigns to borrow more money. (CNBC)

[2] The Forward PD computes the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 12-month Forward 1-year PD is the probability that the firm defaults during the period from 12 months onwards to 1 year plus 12 months, conditional on the firm's survival in the next 12 months.

WeWork bond drops, spread hits a record on report of delayed share tender

Nov 15. WeWork's junk bond price dropped and its risk premium shot to a record high of 13.4 percentage points, following a report of delayed share tender from existing shareholders. The We Company, owner of WeWork, announced net losses more than doubled to USD 1.25bn in the third quarter as costs have outpaced the company's breakneck expansion. The tender, which is supposed to have begun five business days after the initial payment of USD 1.5bn to WeWork was in place, has not been extended yet. However, an investor said that the delays will likely be resolved. (Reuters)

China's USD 1tn scramble for convertible bonds reflects hot market

Nov 12. Shanghai Pudong Development Bank's convertible bond issue last month had a staggering USD 1tn worth of orders for the USD 7bn it raised, indicating that the issue was about 140 times oversubscribed. The strong demand reflects the surge of convertible bond issuances in China, where Chinese firms issued a record USD 40bn in these equity-linked securities in 2019 so far, up more than 80% from the full-year total in 2018. Convertible bonds usually carry a cheaper coupon but gives investors the right to switch them for equity if a company's shares rise to a pre-determined price. For companies, convertibles offer a way to raise money more cheaply than by issuing regular debt and do not immediately dilute shareholders' equity. Convertibles also tend to be looked upon favorably by regulators because they are treated as debt until conversion, meaning investors have a better chance than shareholders of getting some form of repayment if the company goes insolvent. (FT)

Walgreens buyout would be a test of bond investors' appetite

Nov 12. KKR's proposal to acquire Walgreens Boots Alliance sets up a test for debt markets, where borrowing costs are low but investors are worried about risky deals. Walgreens carries about USD 15bn in net debt, accounting for about one-fifth of its enterprise value. Raising enough debt to fund Walgreens buyout presents a challenge for KKR as it depends on whether Walgreens could retain an investment-grade rating for part of its debt and gain access to the investment-grade bond market. Walgreens' bonds are rated BBB or equivalent by major rating agencies, which have yet to respond to news of a potential deal. Meanwhile, the price of Walgreens' bond is hit by the news of a potential takeover, falling 2 cents to trade at 101 cents on the dollar. (FT)

Bond funds lose appeal as yield rise (WSJ)

Riskbank dumps Canadian and Australian debt in green push (FT)

AbbVie sells USD 30bn of bonds to finance Allergan takeover (FT)

Regulatory updates

China's central bank injects funds into banking system again

Nov 16. China's central bank unexpectedly offered CNY 200bn of one-year loans to the banking system to help lenders through the tax season, signaling that larger-scale stimulus is unlikely in the near term. The central bank also released a further CNY 40bn as the result of a previously announced reduction to banks' reserve ratios, taking the total injection to CNY 240bn. Furthermore, policymakers loosened the capital requirements for investing in infrastructure projects this week to prop up output. The interest rate, however, remains unchanged at 3.25%, showing restraint in monetary policy after this week's worse-then-expected economic data. Currently, the central bank stated that liquidity in the banking system is at a reasonable and sufficient level as the operation offsets firms' need for funding to pay tax. (Straits Times)

ECB considers putting climate change risks in future bank stress test

Nov 15. The European Central Bank is considering including climate-change risks in future European banking stress tests amid rising demand for investment to be environmentally sustainable. A methodology for calculating risks related to climate change is not yet fully developed so it's unlikely to be included in next year's European Banking Authority (EBA) stress test, but it could be used in 2022. The EBA stress test is an assessment of risks to the functioning and stability of financial markets across the European Union and it takes place every two years. (Reuters)

India provides creditors path to recover loans from insolvent shadow banks (Bloomberg)

Malaysia's central bank extends repo tenor to 5 years to boost liquidity (Yahoo)

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