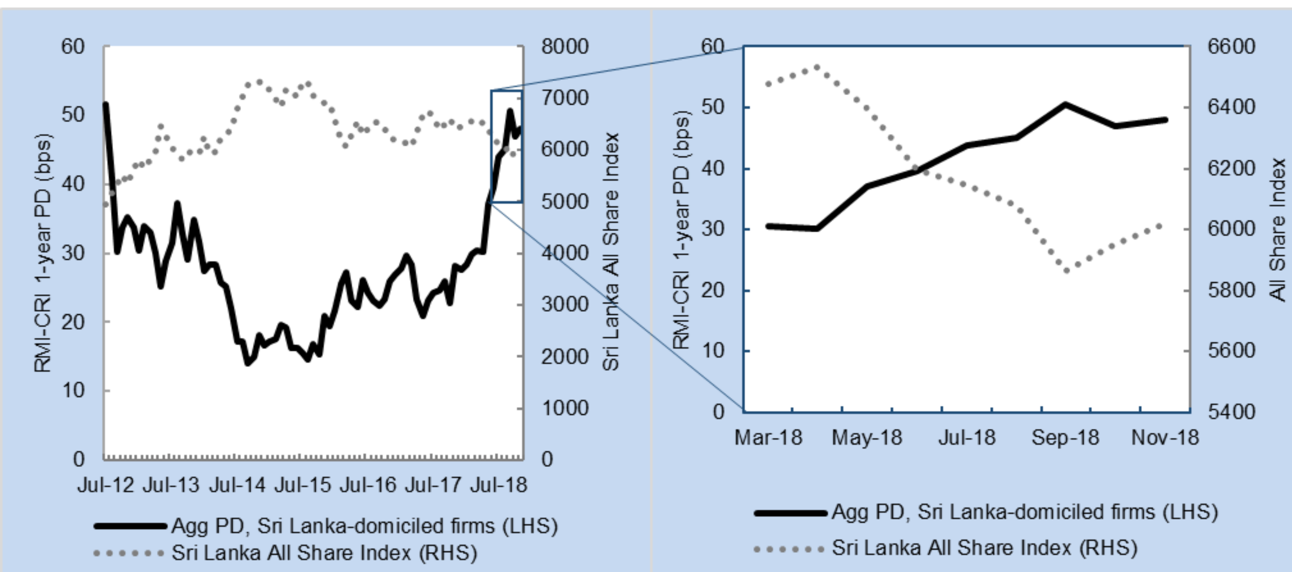
Credit Research Initiative
Risk Management Institute, National University of Singapore
NUS National University of Singapore | RMI
transforming big data into smart data
Weekly Credit Brief Nov 27 - Dec 03

Sri Lankan firms battle an uncertain credit outlook amidst increased political tension

by Dexter Tan

With the possibility of the US pausing its interest rate hikes, the MSCI EM currency index exceeded four month highs, but the Sri Lankan Rupee plunged to a record low against the greenback following a sovereign rating downgrade and possible delay in IMF loan disbursement. The country faced a constitutional crisis in late October when the President Sirisena announced the dismissal of the current prime minister, appointing the former president Rajapaksa in his place. The credit profiles of Sri Lanka-domiciled publicly traded companies, tracked by the RMI-CRI 1-year Aggregate Probability of Default (Agg PD) increased to its highest level from summer 2012, reflecting the heightened political risk that has sent jitters through the local stock and bond markets (See Figure 1a).

The political developments shocked investors as foreigner holdings totaling LKR 18.1bn of stocks and LKR 123.2bn of government bonds were liquidated in the first eleven months of 2018. Sri Lanka's All Share Index, a capitalization-weighted equity performance benchmark of all listed firms, is on track to post its fourth consecutive annual decline this year. The index has dropped nearly nine percent from its 2018 peak and continued political uncertainty may deplete profits and decrease market values. The latter may lead to substantial declines in the firms' RMI-CRI distance-to-default, which is a volatility adjusted leverage measure and significant determinant of RMI-CRI PDs, meaning the credit outlook of Sri Lanka corporates could get even worse in the future.



Figures 1a & 1b: RMI-CRI 1-year Aggregate PD for Sri Lankan firms. *Source: RMI-CRI*

Reflecting deteriorating credit amongst Sri Lanka domiciled companies, the aggregate 1-year PD has been on an uptrend since 2014, albeit at a noticeably accelerated pace in the recent two years. In 2017, floods and a prolonged drought likely weakened the credit profiles of the agricultural and construction sectors while the implementation of the new Inland Revenue Act and reforms to the VAT law suppressed profits for the broader industries. As shown in Figure 2a, the credit metrics for a subset of firms showed average EBITA margins remained low, staying around 10% in 2018 and 2017. The material increase in debt during the last two years also decreased ratios involving operating cash flows (OCF) and debt and increased the debt to EBITDA measure.

Corporate borrowing costs, or the prime lending rate tracking commercial bank loan rates to non-financial firms have remained high since 2016. A high average weighted prime lending rate and falling non-performing loan ratio likely boosted net interest income for banks in 2017. However, a borrowing cost of 11% and average EBITA margin of 10% may have resulted in declining profit margins for non-banking companies. In 2018, the RMI-CRI 1-year aggregate PD for Sri Lankan lenders, and the Non-Performing Loan (NPL) ratio came under upward pressure in the first six months of the year as asset quality on the banks' balance sheet deteriorated.

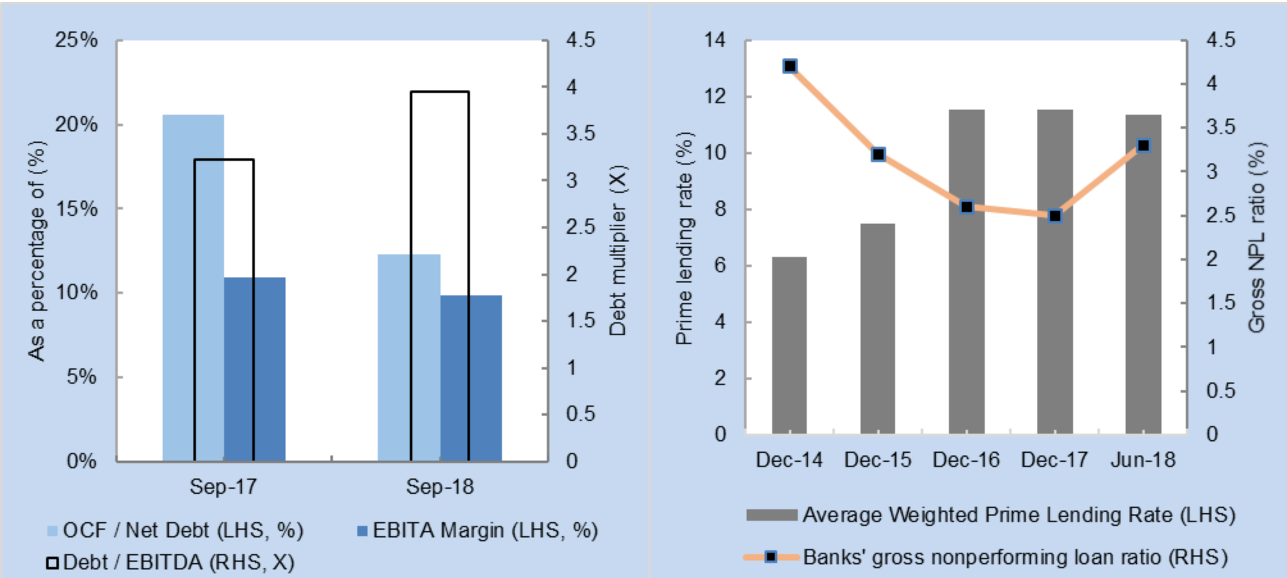


Figure 2a & 2b: Credit metric estimates for Sri Lankan firms as well as lending rates and non-performing loan ratios of the banking sector. *Source: Bloomberg, Central Bank of Sri Lanka*

On its face, Sri Lanka's political tension and currency devaluation could lead to further upside for the country's corporate insolvency risk. Yet this story is not new to developing economies. Overall, 2018 has been a tumultuous year for emerging markets – recall Argentina's sharp decline in its currency, Turkey's financial crisis and South Africa's economic recession in Q2. Elsewhere in emerging markets, Indonesia and India with their low current account deficits also make them susceptible to capital outflows, possibly downgrading their credit outlooks.

Credit News

In rare move, India's top bad-debt buyer eyes consumer loans

Dec 3. Asset reconstruction firms are shifting their focus from bad business debt to soured consumer debt, starting from collateral backed loans first and then unsecured loans like education and credit cards. Bad debt opportunities are expecting to expand ahead. Banks have been increasing amounts of credit to retail consumers after defaults among corporate borrowers eroded their profitability. At the same time, individual borrowers are increasingly missing payments on consumer loans amid weak job creation. Outstanding consumer loans grew almost 18 percent over a year earlier as of end-March 2018. (Bloomberg)

US leveraged loan market is showing signs of sputtering

Nov 30. As money managers grow reluctant to take a risk and buy new loans, the loan prices in the US leveraged loan market have fallen as the year end approaches. Recently, however, the declines have been higher than usual, and the debt has gained about 3.1% this year. Besides, loan offerings are getting pulled at the fastest rate since July. US leveraged loan funds are seeing their biggest outflows in nearly three years. The main US leveraged loan price index fell below 97 cents on the dollar this week, reaching the lowest level since end 2016. It seems like even the best-performing US corporate debt market is showing a few cracks. (Bloomberg)

Credit faces worst year since 2008 as strains intensify

Nov 30. Credit markets are heading for its worst year since the 2008 financial crisis amid rising US interest rates, the Federal Reserve shrinking its balance sheet and the European Central Bank ending its own bond-buying programme. US corporate bond yields have been climbing steadily higher this year and both highly rated investment grade corporate bonds and riskier ones are facing significant redemption pressure alongside further widening of corporate bond spreads. The downgrading pressure is a bigger concern. About half of the debt capitalization of a Bloomberg basket of the asset class carries a triple-B rating, the lowest possible investment grade rung. Further downgrades are expected when in an adverse economic environment or in the event of an exogenous shock. (FT)

China's local government vehicles guarantee USD 1tn in debt

Nov 29. Around 2,000 of China's local government financing vehicles have offered a total of RMB 7tn (USD 1tn) of guarantees to loans, bonds and shadow financing for domestic companies, which surpasses the tally of LGFVs' own outstanding local bonds. These guarantees help private companies get financing as banks prefer to lend to state-owned ones. Such external obligations form part of the hidden debt in China's local governments. While LGFVs have yet to default on their bonds, rising no-payments by the firms they guarantee make them prone to contagion risks. And it's hard for investors to assess risks on companies that LGFVs guarantee and how those contingent liabilities will crystallize because of the limited information available. (Bloomberg)

Banks extend UK plc's overdraft ahead of Brexit

Nov 27. Banks in Britain are trying to prepare businesses after Brexit, including a potential cash crunch and a spike in bad loans with corporate clients, if it leads to delays in cross-border shipments and payments or big swings in sterling. To do so, some banks are extending credit extending credit early to companies and selling insurance against volatility in sterling. Concerns of a potential rise in bad loans have depressed British bank stock prices and delayed capital returns for long-term investors. Some British companies have also been taking action to protect against potential Brexit disruption. Some retailers are increasing inventories of some products in preparation for any supply problems. (Reuters)

South Africa business confidence at lowest since junk rating (Bloomberg)

China's offshore creditors watch for a new kind of default (Bloomberg)

S&P flags credit-boom risks in China amid trade war (Reuters)

Regulatory Updates

China's central bank backpedals on policy to cut debts

Dec 3. In early 2018, Beijing set out to reduce the excessive debt to avert a looming financial crisis by a crackdown on shadow banking, whose customers are usually shell companies set up by local governments and private-sector companies that cannot borrow from normal banks. The measures taken have resulted in infrastructure projects stalled while local governments could still ask provincial governments for help but leave private-sector businesses nowhere to turn for financing. With the Chinese economy cooling due to the escalating trade war with the U.S., China's central bank finally backpedals on policy to cut debts. And Yi Gang, governor of the PBOC, apologized for the bank's policy failure, which has led to difficulty in private-sector financing. (Nikkei Asian Review)

Euro area financial stability environment has become more challenging

Nov 29. The latest Financial Stability Review (FSR) from the ECB says the euro area financial stability environment has become more challenging since May. Downside risks to the global growth outlook have become more pronounced since May relating to a resurgence in protectionism and stress in emerging markets. In the euro area, political and policy uncertainty, related to market concerns about public spending plans have increased over the review period. In addition, the possibility of a cliff-edge Brexit could pose a risk to financial stability. The FSR also highlights risks building up in the investment fund sector. Growing exposures to illiquid and risky assets make the funds vulnerable to potential shocks in global financial markets. (ECB)

PBOC's record liquidity forbearance seen as sign of credit woe (Bloomberg)

Australian regulators watching non-banks for financial stability risks (Reuters)

Published weekly by Risk Management Institute, NUS | Disclaimer
Contributing Editor: Dexter Tan