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Benefiting from increasing energy prices, Russian oil and gas companies display lower credit risk than their global peers

by Wang Anyi

- **Concurrent with soaring oil and gas prices, Russian oil and gas companies' credit profiles improved more than global peers as demonstrated by the NUS-CRI Agg PD on the back of stronger profitability and lower leverage**
- **Despite the transition to greener energy sources, the NUS-CRI Agg Forward 1-year PD indicates that the Russian oil and gas industry faces lower credit risk compared to its global counterparts as a result of supportive government policies**

The recent energy crisis witnessed across Europe has thrown a spotlight on Russia's oil and gas industry, given its position as a superpower in the global energy landscape and the largest energy supplier for Europe. On the back of global economic recovery, as countries emerge from lockdowns, oil prices have climbed rapidly over the past year, reaching the highest level since 2018, as tracked by the European Crude Dated Brent Spot (See Figure 1a). Dutch TTF, the European gas benchmark, has also rallied 290% since Q2 2021. This has been a result of a global energy supply deficit as countries scramble to meet energy demand to fuel rising economic activity. Concurrent with the rise in the oil and gas prices, Russian oil & gas companies saw their credit profiles steadily improve over the past year, contributed by a lower debt burden and stronger profits, as their NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) fell below the BBB+ upper bound according to PDiR2.0[1]. However, the NUS-CRI Agg Forward 1-year PD (Forward PD[2]) suggests that over the short-to-medium term, the global oil and gas industry may experience deterioration in their credit quality, driven by a lack of capacity and shifting demand due to energy transition. However, Russian oil and gas companies face relatively less risk given the favorable government policies compared to their global counterparts.

[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 similar 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, conditional on the firm's survival in the next 6 months.

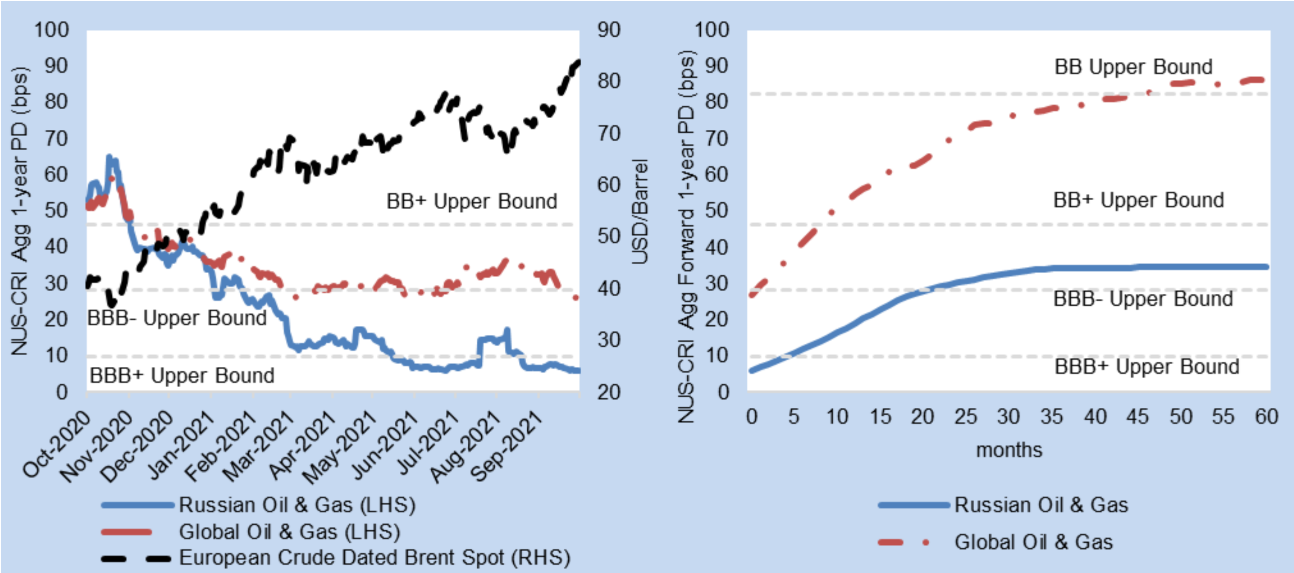

Figure 1a (LHS): NUS-CRI Agg 1-year PD for Russian oil & gas companies and Global oil & gas companies with reference to PDiR2.0 bounds and European Crude Dated Brent Spot (USD/Barrel) from Oct-2020 to Oct-2021. Figure 1b (RHS): NUS-CRI Forward 1-year PD for Russian oil & gas companies and Global oil & gas companies as of Oct-2021 with reference to PDiR2.0 bounds. *Source: NUS-CRI, Bloomberg*

An important driver of the lower credit risk of the Russian oil and gas industry is their lower debt burden. Despite the capital-intensive nature of the oil and gas industry, it has managed to maintain low leverage[3], with the median Total Debt/Capital staying below 22% over the past 2 years. Its median Total Debt/EBITDA was 1.42 at the end of Q2 2021, in contrast with 2.37 globally. Moreover, Russian oil and gas companies' stronger profitability also explains the greater improvement in their credit profile amidst the uptick in oil and gas prices. As one of the critical pillars of the Russian economy, Russian oil and gas companies operate at the lowest cost of production in the world as a result of the well-developed field infrastructure, combined with efficient railway and pipelines. In the context of rising prices, the domestic industry's median ROA has been increasing since the end of last year and currently stands at 6.8% (See Table 1). The global median ROA, however, was negative throughout 2020 and measured at 0.5% in Q2 2021.

	Q2 2020	Q3 2020	Q4 2020	Q1 2021	Q2 2021
Total Debt/Capital (%)	21.87	21.70	20.29	19.03	18.66
ROA (%)	4.12	1.74	1.04	3.50	6.83
Total Debt/EBITDA	1.46	2.33	2.39	1.96	1.42

Table 1: Total Debt to Capital (%), ROA (%) and Total Debt to EBITDA for Russian oil and gas companies from Q2 2020 to Q2 2021. *Source: Bloomberg*

The increasing Forward PD in Figure 1b indicates that both Russian and global oil and gas companies may experience deterioration in their credit qualities. One common risk that they face is the lack of capacity to meet rising demand in the short-to-medium term. The industry's underinvestment in production capacity especially in the upstream business makes it hard for oil and gas producers to fill the supply gap, contributing to the current energy shortage. To stay in step with demand, the collective investment needed amounts to USD 500bn. As the global spare capacity depletes, it will be necessary to reinvest in not only maintaining but growing production to meet the global demands for oil and gas. Although a forecasted rise in oil and gas prices persisting into the winter should bode well for revenue and profit, the investment required to meet the demand may impede their free cash flows of all oil and gas companies.

Structurally reduced demand brought on by the green energy transition could pose a risk in the long run (See Figure 1b). Russian oil and gas companies that have benefited from a strong consumer base across Europe may face wide demand pressures in the long term stemming from this transition. However, the risk arising from this transition may be limited in the near future, mostly because the clean energy market is currently not mature enough to shift demand away from oil and gas. Moreover, as Russia holds significant pricing power over

[3] Russia's growing access to Asian capital, especially from China, relieved its financing pressure. China is a key provider of large-scale financing, including loans and equity investment.

Europe's energy supply, the approaching winter leaves the continent potentially relying more on Russia. Namely, Russian companies may not face this much pressure on their revenue-generating capabilities in the short run.

Unlike other major carbon emitters, the Russian government has not set a plan for the transition away from oil and gas into cleaner energy. While oil and gas projects are hindered from financing due to ESG concerns in other countries[4], Russian oil and gas companies are well supported by concerted government measures including tax breaks, currency devaluation, and favorable bail-out schemes[5]. Thus, the Russian government can be expected to have the willingness and ability to provide support for oil and gas companies given their critical role in the economy.

[4] Countries in Europe have set ambitious goals to abolish fossil fuels which hinder the financing of oil and gas projects. For example, the European Bank for Reconstruction and Development (EBRD) no longer invests in upstream oil and gas projects, financing only projects in line with the Paris Agreement. In the US, Biden's green push will constrain oil and gas companies' capacities as well.

[5] For example, in 2020, President Putin has tasked the government with implementing a set of measures aimed at supporting the oil industry for the duration of the OPEC+ production cut agreement.

Credit News

Evergrande crisis leaves Chinese developers shut out of global debt markets

Oct 14. International bond sales by Chinese developers have come to a standstill as fears of default in the property sector keep investors away. The effective yield on an ICE index of Chinese corporates jumped to 24% this week from 10% in June, as the possibility of the Evergrande crisis spilling over to the entire property sector gains contagion fears. Analysts at Fitch estimate that a third of outstanding cross-border bond obligations by China's real estate sector is expected to mature by the end of next year. The rise in funding costs for high yield issuers, because of the Evergrande crisis, is going to make refinancing difficult. If lending to developers is cut off, the contagion will spread to lenders which have extended finance to these property developers. The threat of contagion may spur Chinese authorities into action as they seek to avoid spill-over effects of the crisis on other sectors. (FT)

Junk loans shine as investors pile into riskiest parts of CLOs

Oct 14. Investors have been raking in large profits in the USD 805bn United States Collateralized Loan Obligations (CLOs) market. The lowest-rated securities related to CLOs generated more than 29% this year through August. In contrast, the S&P 500 returned 21.5%. CLO equity securities' strong returns are attracting more investors. These leveraged loans are frequently used to fund private-equity buyouts of companies that have a high debt-to-earnings ratio, or leverage. The economy's recovery and investors' desire for CLOs' relatively high yields are expected to keep the demand for CLOs high. This is especially so since the safest CLOs are yielding more than ordinary debt. Triple-A-rated CLO securities returned 1.2% to investors in the third quarter of this year. In contrast, investment-grade corporate bonds returned -1.1%, while Treasuries returned -2.7%. The increasing demand for CLOs has improved liquidity in the market for the lowest-rated securities (WSJ)

China eases mortgages for rest of year on Evergrande contagion worries

Oct 15. Amid growing concerns of contagion from Evergrande's debt crisis, financial regulators have told some of China's major banks to loosen restrictions on home loans and accelerate approval of mortgages in the last quarter. Banks were also permitted to apply to sell residential mortgage-backed securities to free up loan quotas, easing a ban imposed early this year. As default risks mount for developers after a cap on banks' exposure to the real estate sector since the beginning of the year dried up loans, regulators have signaled a willingness to prop up healthy property firms by asking banks to refrain from cutting off funding to developers all at once. China's credit growth slowed in September, as weakness in the property market weighed on financing and lending activities. Meanwhile, combined contracted sales by its top 100 real estate companies tumbled 36% in September from a year earlier, putting pressure on the economy. (Bloomberg)

Rising mortgage rates shift lenders' focus to home buyers

Oct 17. Last week, the average rate on 30-year fixed mortgages increased to 3.05%, the highest since April. The rising rates could have slowed down refinancing rates, hurting lenders whose growth depended heavily on refinancing during the pandemic housing boom. However, with the housing market still booming, lenders have shifted their focus to homebuyers who still need financing to close out their home deals. Purchase mortgages have grown since the start of the year and made up close to half of total loans packaged into government-backed securities in the third quarter. This has driven lenders that focus on the purchase market instead of the refinancing market, such as U.S. Bancorp, to thrive recently. (WSJ)

PBOC's Yi says China can 'contain' the risk from Evergrande

Oct 17. According to the People's Bank of China (PBOC) governor Yi Gang, China Evergrande Group's troubles, which is posing hazards to the Chinese economy and financial system can be managed. As Chinese President Xi Jinping maintains strong efforts to cool the overheated housing market, fears have increased that Evergrande's liquidity problem will spread to other developers. Fears have grown in recent weeks, following Fantasia Holdings Group's unexpected default and Sinic Holdings Group cautioning that its default was impending. Evergrande's liabilities, are widespread in the banking system, with "not much concentration." China's economy has slowed due to increasing default risk for some companies, stemming from rapid expansion and risk-on debt management. After increasing at the fastest pace in nearly 26 years last month, producer price inflation is anticipated to drop by the end of the year. (Bloomberg)

Bond platform Trumid raises $208m as Wall Street bets on electronic trading (FT)

China credit growth slows amid property, Evergrande troubles (Bloomberg)

US banks take diverging bets on direction of interest rates (FT)

Regulatory Updates

ECB considers boosting purchases of EU recovery fund debt

Oct 17. The European Central Bank (ECB) is considering increasing the limit on its purchases of EU-issued bonds from the current cap of 10%, to enhance its flexibility on government bond purchases and to boost the status of the EU bonds into a regional benchmark. However, concerns are present regarding the increase of asset purchases outside of periods of financial crises, which could cause an over-reliance on the government to support high levels of debt in the future. The ECB is expected to announce that the EUR 1.85tn pandemic emergency purchase program (PEPP) will end in March 2022, but with the apparent risk of inflation due to soaring energy prices and supply chain disruption, the ECB is projected to expand its asset purchase program up to the end of 2023. (FT)

Libor deadline prompts surge in CLO issuance

Oct 15. With the impending Libor deadline, issuance of collateralized loan obligations (CLO) has soared to a record high this year. Total issuance in 2021 reached USD 140bn in October, surpassing the previous full-year record of just under USD 130bn in 2018. August and September marked the largest issuance months for CLOs on record. Additionally, as inflation pressures mount and the Fed prepares to withdraw support for financial markets, rising interest rates have rekindled demand for floating-rate investments like CLOs whose interest payments rise and fall with benchmark rates, insulating investors from the prospect of interest rates moving even higher. Companies have binged on cheap loans throughout the pandemic, which has provided a huge source of debt to package up into CLOs. These instruments are the biggest buyers of leveraged loans, helping companies borrow record amounts of cash this year, with those new loans serving as collateral for new CLO deals. (FT)

Bailey says Bank of England 'will have to act' on inflation (Bloomberg)

Fed rate hike in June has become a coin flip as yields climb (Bloomberg)

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