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US offshore transportation service provider risks losing on its home turf

by Budi Andoro HARTANTO

The US offshore service industry was taken aback when the US Customs and Border Protection (CBP) decided to revoke a marine statute that regulates permission for certain foreign vessels to operate in US waters. Under the statute, known as the Jones Act, merchandise moving between two ports in the US must be carried on vessels that are US built, US owned and have US crews. The action drew both praises and criticisms from different parties, as proponents believe that it would allow the US oil and natural gas industries to tap into the competitiveness of the real capital market to generate higher revenue and create jobs. Opponents, mainly hailing from the maritime industry, claimed that it would hurt their industry and create job losses.

Among the US-based offshore fleet providers, we turn our attention to Hornbeck Offshore Services Inc. (HOS), a major oil company service provider, where the impact of the statute repeal may start to take a toll on its future. Its operating margin has consistently been in the negatives since Q1 2016 with Q4 2016 recording the worst ever loss of 65.67% and a negative outlook ahead. As shown in Figure 1, the RMI-CRI 1-Year Probability of Default (PD) for HOS is on an upward trend since end of January 2017 to 984.3 bps, exceeding the record high 1-year PD in 2016.

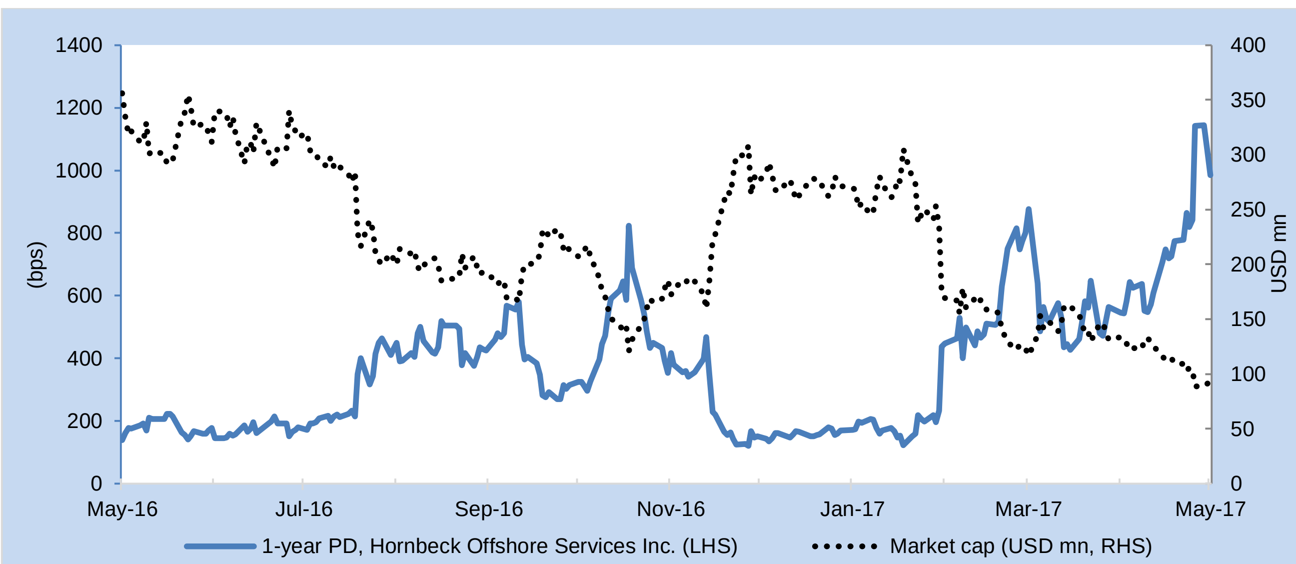

Figure 1: RMI-CRI 1-year PD for Hornbeck Offshore Services Inc. vs market capitalization. *Source: RMI-CRI, Bloomberg*

	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017
Revenue (USD mn)	76.80	53.70	51.90	41.90	53.50
Free Cash Flow (USD mn)	-4.60	-32.50	1.90	-8.90	-7.20
Operating Margin (%)	-0.96	-40.08	-27.97	-65.67	-24.87
Net Debt/Equity (%)	56.50	59.19	59.98	61.77	63.56
EBITDA/Interest Expense (X)	2.50	0.63	1.06	1.08	0.14
Net Debt/EBITDA (X)	3.83	6.71	10.63	17.57	37.23

Table 1: Financial Data for Hornbeck Offshore Services Inc. *Source: Bloomberg*

HOS attributed its deteriorated figures to poor performance in the offshore service industry in general and high cost of deep water drilling surrounded by moderate revenue performance, causing a low utilization rate of its fleet of new generation Offshore Support Vessels (OSV) and hence its day rates. During its Q1 2017 earnings call, it reported a YoY utilization rate drop to 20% from 35%. In the US Gulf of Mexico, where the company's core market is concentrated, the company overestimated the number of deepwater drilling units to support its current fleet of OSVs, possibly causing the company to incur overstocking costs. Outside the US Gulf of Mexico, the company is faced with a challenging business environment due to both bureaucratic obstacles and a protective vessel market. This might spell trouble as the company is not only in fear of losing out in its home turf in the US after the Jones Act repeal, but also faces stiff competition amid overseas governments' tough stance on allowing foreign vessels in their waters.

HOS is also currently struggling to beef up its cash reserves to pay up its three tranches of debt maturing in 2019, 2010 and 2021 worth USD 300mn, USD 375mn and USD 450mn, respectively. The firm's EBITDA/Interest Expense decreased from 2.5X to 0.14X, so much so that it explicitly indicated a possible inability to refinance its maturing debt obligations in both its 2016 annual report and Q1 2017 earnings call. Its Net Debt/EBITDA, a proxy for financial leverage, has also skyrocketed by almost 10 times to 37.23 in Q1 2017 compared to 3.83 in Q1 2016, adding another dimension of risk to its creditors. With a net loss of USD 63.8mn in 2016 and USD 217mn of cash and its equivalents in hand at beginning 2017 amid unsatisfactory performance, mounting interest expenses, and increasing Net Debt/Equity, it seems like HOS may need to think of alternatives to issuing bonds for refinancing so that it does not get stuck in a debt meltdown.

Unfortunately, the problem just does not stop there for HOS. In a recent development in the oil market, US shale oil companies are making a comeback as they are predicted to wage an unfinished price war with top oil producing countries like Russia and cartels such as OPEC. Hence, plans to cut oil output in the short and near long term by the non-US oil giants might not yield the desired effect of pushing oil prices above USD 50/barrel. Should the price of Brent, a proxy for the general price of oil, decline below this threshold, then this might discourage the use of offshore services due to unprofitable oil drilling activities and adversely affect HOS' performance later on. Subsequently, other surviving US-based offshore service companies, which are currently in a benign condition, might be in for a tough ride as the upcoming oil market instability will put their balance sheets' health to the test. Unless HOS is able to come up with brilliant ideas to capitalize more on its fleets and improve liquidity without getting rid of its valuable assets, the outlook seems to be gloomy for this former budding offshore service company.

Credit News

Banks tighten auto lending as more borrowers fall into default

May 17. Increased difficulty for consumers in the US to secure auto loans is beginning to show as banks tighten loan requirements for borrowers with weak credit. The move came as a result of surging delinquent auto loans and banks are looking to cut down on riskier credit. With the emphasis on safer deals, the percentage of subprime borrowers fell from 30% a decade ago to less than 20% currently. This can lead to falling sales and revenue for automakers who have relied heavily on loose credit for growth. Traditional auto loan lenders like Ally Financial are fending for themselves and continue to shift away from subprime borrowers despite the impacts this might have on the auto industry. (Bloomberg)

Rue21 bankruptcy pushes retail default rate higher

May 17. The loan default rate for US retailers has increased to 1.7% from 0.9% with the bankruptcy filing of Rue21. The fashion and accessories retailer filed for bankruptcy protection last Monday after its customers fled to online stores and other fast fashion outlet, reflecting the woes of other mall based chains. Fitch Ratings has identified a list of 11 issuers that could potentially default on their debt obligations within the next 21 months. These include listed firms such as True Religion Apparel, Sears Holdings, Chinos Intermediate Holdings and Gymboree. (Marketwatch)

Bank default traps pension fund in Azeri debt restructuring

May 19. Kazakhstan's state-run single pension fund suffered a major blow of having to restructure USD 3.3bn in debt after investing USD 250mn into bonds issued by the International Bank of Azerbaijan (IBA), the nation's biggest lender that defaulted last week. The central bank managed pension fund went to distress after oil prices fell by more than half and sent the Azeri currency tumbling by more than a quarter. The restructuring, which according to Moody's might result in more than 20% loss for creditors, was claimed to be a consequence of poor risk management in a sense that IBA sold its bonds in a private placement, making it hard to sell the purchased securities. IBA has seen a decrease in its USD 500mn 2019 dollar bonds and an increase in the yield of the government's dollar notes maturing in 2024. This came at a terrible timing as the event coincided with Azerbaijan's currently unsound financial system resulting from a widening liquidity gap reported by IBA. (Bloomberg)

US household debt surpasses pre-crisis peak

May 17. Consumer debt balance in the US is totaling to USD 12.73tn at the end of the first quarter of 2017, exceeding the pre-crisis peak of USD 12.68tn in 2008. However, composition of the debt balance is significantly different from the 2008 period. Share of bad debts in current period is much lower than it used to be during the 2008 pre-crisis peak. Mortgage borrowers' finances stood out to be particularly robust and solid as lenders are more cautious about extending loans to those with weak credit records after the subprime mortgage crisis. A comparison revealed that only 3.5% of home loans defaulted on payment as compared to annualized figures of at least 10% from third quarter 2008. However, student debt remains a problem with an annual delinquency rate of approximately 10%. Outstanding student loans have reached USD 1.34tn and surpassed credit cards to have the worst delinquency rates. In other areas, credit card and motor loans are also showing signs of deteriorating performance. (FT)

Interest-only loans could be 'Australia's sub-prime'

May 21. JCP Investment Partners, a Melbourne-based fund has warned that defaults on risky mortgages extended to young families and over-extended borrowers could wipe out 20 percent of the banks' equity. JCP's extreme scenario assumes a sharp housing correction while a more conservative estimate projects a 40 percent loss resulting in banks losing USD 24.2bn in total due to loan losses. Australians have continued to borrow at an alarming rate, leading to a situation where interest only loans have increased to 42 percent of all mortgage credit. (AFR)

S&P lifts Indonesia's credit rating to investment grade (Straits Times)

Why banks are betting on perpetual bonds (Economic Times)

Regulatory Updates

Mifid II threatens to turn bond allocation into a minefield

May 19. Regulations on bond allocation will be made more stringent with the EU's Mifid II regulation taking effect from January in the form of providing of a justification for the final allocation made to each investor in a bond sale. This, however, sparked concerns among experts and bankers as retail investors are likely to be avoided due to higher legal risks potentially incurred, depleting the secondary market of liquidity and causing buyers to bid for more bonds than they actually want. This also posed a challenge to bond sales by European high-yield bond syndications, which differ greatly in conventions to those by investment grade bond syndications. (FT)

Call for transparency on ECB corporate bond buying

May 19. The ECB has been buying up corporate bonds as part of the economic stimulus programme. However, lawmakers in Europe are calling for greater transparency over these purchases for fear that the purchases are only benefitting a small group of companies. Currently, central banks in the Eurozone are only required to disclose the names of companies which they have bought bonds from but not the size of each holding. Lawmakers are petitioning for a company-by-company disclosure of the securities being bought. About EUR 75bn have been spent on purchasing corporate bonds. The quantitative easing programme is expected to continue for the rest of the year at a rate of EUR 60bn of bond purchases per month. (FT)

Hong Kong central bank unveils fresh measures to check property price surge (Reuters)

Solvency II data reveal gaps in insurers' capital positions (FT)

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Contributing Editor: Dexter Tan