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Weekly Credit Brief Apr 18 - Apr 24 2023

Upstreaming dividends bleed the credit health of Indian mining giant Vedanta Ltd.

by Amrita Parab

- **NUS-CRI PD indicates a deterioration in the credit health of Vedanta Ltd. amidst a downtick in commodity prices and related recessionary headwinds**
- **NUS-CRI Forward PD suggests that continued high dividend payouts and expensive debt refinancing could deteriorate the credit outlook of Vedanta Ltd.**

Vedanta Resources Ltd., the parent holding company of one of the largest mining conglomerates in India, has been embattled in a desperate bid to deleverage over the past year. To fund the repayment of its upcoming debt maturities, the company has been using funds provided by its subsidiaries, mainly Vedanta Ltd. (VEDL)[1], which is a major publicly-listed operating subsidiary of Vedanta Resources. The NUS-CRI 1-year Probability of Default of VEDL increased in 2022 as the firm accelerated upstreaming dividends to Vedanta Resources in an effort to provide it with necessary funds, even as commodity prices plummeted and fear of recessionary headwinds worsened investor sentiment. Going forward, the NUS-CRI Forward 1-year Probability of Default (Forward PD[2]) crosses the B- upper bound in the near term, suggesting that continued high dividend payouts may burden VEDL's liquidity. With its own borrowing costs increasing, expensive debt refinancing could provide further hurdles to VEDL's credit profile.

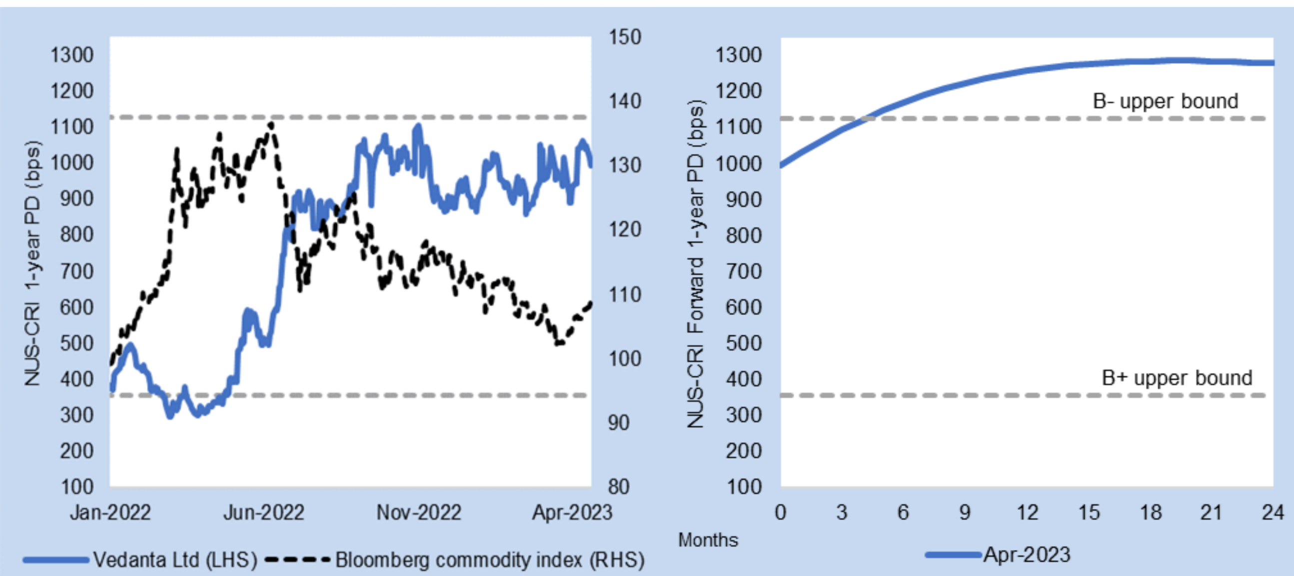

Figure 1a (LHS): NUS-CRI 1-year PD for Vedanta Ltd. with reference to PDiR2.0[3] bounds along with the Bloomberg commodity index. Figure 1b (RHS): NUS-CRI Forward 1-year PD for Vedanta Ltd as of Apr-2023. with reference to PDiR2.0 bounds. *Source: NUS-CRI, Bloomberg*

Over the past year, Vedanta Resources has been working to lower its debt load and develop a plan for managing its upcoming debt obligations. As a holding company, Vedanta Resources has typically repaid its debt obligations through bank loans, capital market funding, and dividend payouts from its subsidiaries. However, due to the current conditions of high-interest rates, scarce market liquidity, and tight credit conditions, Vedanta Resources has increasingly relied on dividends from its subsidiaries, particularly VEDL, to service its debt. Specifically,

[1] Vedanta Ltd. is one of the world's largest natural resource conglomerates, with main operations in zinc-lead-silver, iron ore, steel, copper, aluminum, power, nickel, and oil and gas. Vedanta Ltd. is a subsidiary of Vedanta Resources Ltd..

[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 by 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.

VEDL's dividend payout of USD 4.6bn, over the past twelve months, is higher than twice the dividend amount in the previous fiscal year, which has helped Vedanta Resources meet its Apr-2023 debt obligations, reducing its gross debt by USD 1bn. However, with USD 4.2bn in bond maturities expected over the next three years for Vedanta Resources (see Figure 2a), VEDL credit quality is expected to decline. Moreover, VEDL itself has 38% of its debt that will mature over the next 18 months, and refinancing those debts in the current environment may prove to be expensive, as evidenced by the rising yield of its bond (see Figure 2b).

	Mar-2021	Jun-2021	Sep-2021	Dec-2021	Mar-2022	Jun-2022	Sep-2022	Dec-2022
Dividend yield (%)	4.15	3.61	9.73	7.91	6.57	19.96	18.89	26.43
Profit margin (%)	23.08	15.03	15.36	12.36	14.74	11.55	4.98	7.31
Interest coverage ratio	5.27x	6.55x	7.73x	6.96x	8.44x	6.41x	3.09x	2.76x

Table 1: Financial metrics of Vedanta Ltd. *Source: Bloomberg*

Taking into context VEDL's upstreaming dividends to its parent, VEDL's financials are also impacted by a slowdown in commodity prices. VEDL's profit margin has been declining since Q2 2022 as demand moderates and commodity prices weaken amidst global recessionary headwinds. The resultant impact has worsened the company's debt servicing ability, with the interest coverage ratio reducing steadily since the middle of last year (see Table 1). Liquid assets have also been worsening, with the company's cash position decreasing by 8.5% and 13.3% in Q1 and Q3 2022 respectively.[4] The Forward PD in Figure 1b suggests that the financial position of the company is likely to worsen in the short term, possibly due to Vedanta Resources' continued reliance on VEDL for funds that may worsen the latter's liquidity and debt servicing capability. As VEDL contends with higher dividend payouts amidst upcoming debt maturities, the company's capital expenditure may also remain subdued, thus limiting potential capacity expansion and consequently further reducing the company's revenue-generating capabilities.

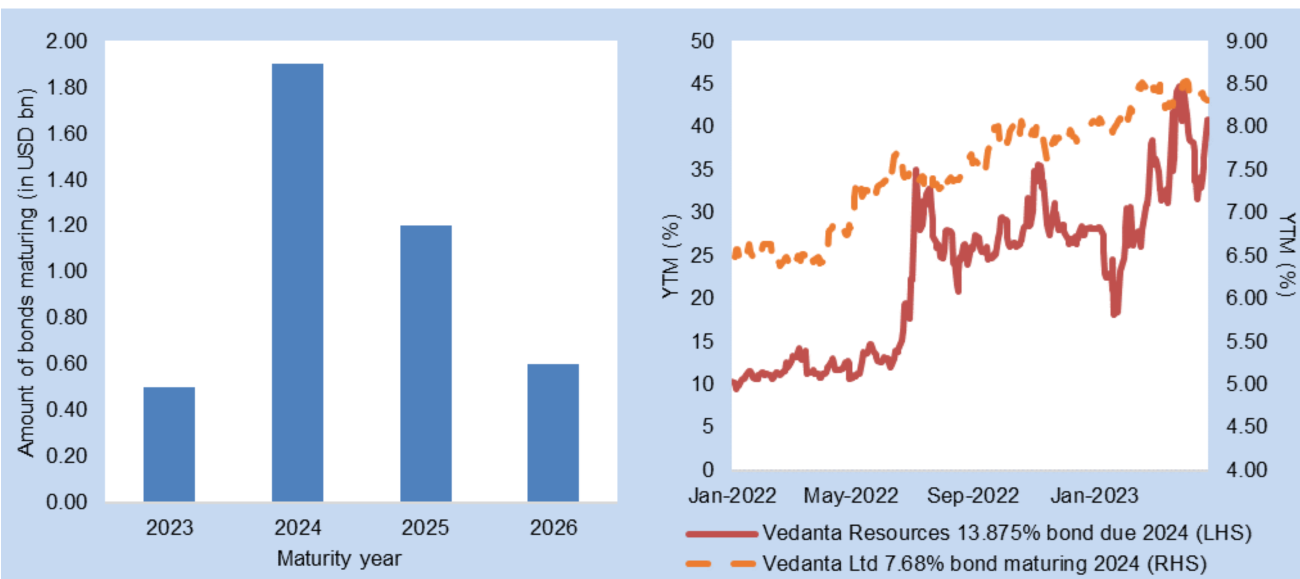

Figure 2a (LHS): Total amount of bonds maturing (in USD bn) for Vedanta Resources Ltd.; Figure 2b (RHS): Mid yield to maturity (%) of Vedanta Resources Ltd. bond due 2024. *Source: Bloomberg*

Vedanta Resources' dependence on the dividends from VEDL may not abate in the near term as the higher perception of risk keeps its cost of financing high. As seen from Figure 2b, the yield to maturity of Vedanta Resources' bond maturing in 2024 has climbed to 40%, signaling that it is extremely expensive for the firm to borrow from capital markets. Vedanta Resources has tried several avenues to raise funds such as pledging subsidiary shares, borrowing from credit funds, and asset sales. In a recent bid to upstream cash to the parent, Hindustan Zinc (HZL), a subsidiary of VEDL, proposed to buy VEDL's global zinc business for a cash consideration of USD 2.98bn. However, this deal faced significant opposition from minority shareholders of HZL, especially the Indian government which holds 29.54%. In addition, the sale of assets in an all-cash-deal between subsidiaries and the parent can be classified as a 'related party transaction' that requires the majority of the subsidiary's minority shareholders to approve the transaction, making it unlikely. Should this deal fall through,

[4] Data from Bloomberg

the parent entity will again be scrambling to secure funds. In such a scenario, Vedanta Resources will likely continue tapping into dividends from VEDL for liquidity, possibly suggesting why the Forward PD in Figure 1b continues to rise in the short term.

Vedanta Resources Ltd.'s over-reliance on its subsidiaries for funds has made VEDL overly exposed to negative investor sentiment. As contagion risk trickles through investor sentiment on VEDL's share and bond prices, the resultant impact on their PD is likely to be high. A potential restructuring of the upcoming debt of Vedanta Resources could provide the liquidity of VEDL with some much-needed breathing space to shore up its own finances. Given that the macroeconomic climate does not improve, and commodity prices remain depressed, VEDL's profitability is likely to remain muted in the near term, worsening the credit risk outlook for the publicly listed subsidiary as suggested by NUS-CRI's Forward PD.

Credit News

US regional banks' stability comes at a price after SVB's collapse

Apr 21. Regional banks in the US have stemmed the flow of deposit outflows that threatened their stability in the wake of the Silicon Valley Bank collapse but are being hit by unexpected declines in profit margins. More than a dozen mid-sized banks reporting earnings this week warned of heightened competition for deposits following SVB's demise, forcing them to increase the rates they pay to savers and hitting earnings. The rising interest rates from historically low levels that banks had anticipated as the source of bumper profits for lenders failed to materialize due to the Federal Reserve's rapid rate increases, persistent inflation, and the recent fears over SVB's collapse. (FT)

Home prices in March posted biggest annual decline in 11 years

Apr 20. US home sales fell 2.4% in March from the previous month to a seasonally adjusted annual rate of USD 4.44mn, the National Association of Realtors said, marking the 13th time in the last 14 months that sales have slowed. Housing prices are being impacted with the national median existing-home price falling 0.9% in March YoY to USD 375,700, marking the biggest YoY price drop since January 2012. The number of new listings in March fell 20% from a year earlier. The slowdown in the housing market is being attributed to rising mortgage rates, high home prices and low inventory. (WSJ)

Corporate bonds are being cut to junk at fastest pace since 2020

Apr 20. Credit rating agencies are expected to cut most US corporate bonds to junk since the early stages of the pandemic. The first quarter saw USD 11.4bn of bonds downgraded to high-yield status, equivalent to 60% of the total for 2022. The bank's research suggests the full-year volume is on course to be the highest since the pandemic started. The downgrades come as the Federal Reserve hikes interest rates, increasing borrowing costs for companies, and as economic growth slows. Barclays expects downgrades to accelerate in H2 2023 as the strain on blue-chip borrowers intensifies due to slowing economic growth. (Bloomberg)

Fed's Williams says banking stress likely to tighten credit

Apr 20. The head of the New York Federal Reserve, John Williams, has said that households' and corporates' access to credit may be hindered following the recent banking crisis. Though he believes that the banking crisis has passed, due in part to the Fed's backstop facilities, credit conditions are to tighten, weighing down spending. The US economy has already started to show signs of weakening following the crisis, with hiring and growth stalling in recent weeks. Mr Williams still expects modest positive economic growth for 2023, with inflation falling to 3.25% by end-of-year. However, it is likely that the banking sector's crisis is still ongoing, with shares of First Republic Bank plunging due to a depositor flight of 20% of its depositor base. (Bloomberg)

US ESG bond market chokes on republican backlash, investor angst

Apr 19. Issuance of ESG bonds has been down 50% YoY in the US as investors and politicians aim to ban ESG-related investing. The political assault on ESG by prominent members of the US republican party aims to discontinue ESG investing in 19 states. Some states are prohibiting pension funds and other investment pools from considering ESG criteria, reducing borrowers' incentive to issue ESG debt. The onus now falls on asset managers, that now have to justify investing in ESG-related securities for reasons other than just the 'ESG' label. Some are proponents of this change, arguing that investors understand that ESG investing does not provide the expected returns, and that the ESG market tends to distort the free-market incentives that aim to do the same policy objectives. (Bloomberg)

Japan's SMFG is first global bank to sell AT1 bonds since C.Suisse wipeout (Reuters)

Evergrande's offshore debt restructuring hits another barrier (Nikkei Asia)

ETFs offer a route to much-needed bond market liquidity (FT)

Regulatory Updates

Australia plots biggest shake-up of central bank in decades

Apr 20. The Reserve Bank of Australia (RBA) is planning a significant overhaul in its conduct of monetary policy, with a creation of a Monetary Policy Committee (MPC). This would make RBA's policy-setting system like that of Canada and England. The new system is likely to reduce the power of RBA's governor on key decisions such as interest rates. The bank is going to meet eight times a year to set key interest rates, compared to the current eleven times, while the policy rate target of 2%-3% remains unchanged. Given the new changes, market participants are anticipating that the current governor, Philip Lowe, will be replaced at the end of his term in Sep-2023. Australia's long history of economic growth before the pandemic is being attributed to RBA's successful monetary policy targeting, as such, the new changes are being heralded as a 'modernization' process rather than a reflection on the central bank's current governance and policy-setting structure. (WSJ)

China's central bank vows 'appropriate' rates in lesson from SVB

Apr 20. The People's Bank of China (PBOC) has stated that it plans to manage interest rates and credit availability 'appropriately' amidst SVB's banking crisis. PBOC has pledged to maintain reasonable growth in credit and money and keep interest rates appropriate, hinting at low interest rates for the near future to avoid a similar crisis to the one seen in the US. However, economic data from China suggests that low inflation, even as credit condition improve, are signs of slowing demand. As such, concerns are rising about new credit extension by PBOC remaining in financial institutions rather than trickling into the real economy. (Bloomberg)

BOE official tells hawks that rates are too high for economy to withstand (Bloomberg)

Singapore's MAS plans for ESG rules, pushes transition finance (Bloomberg)

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