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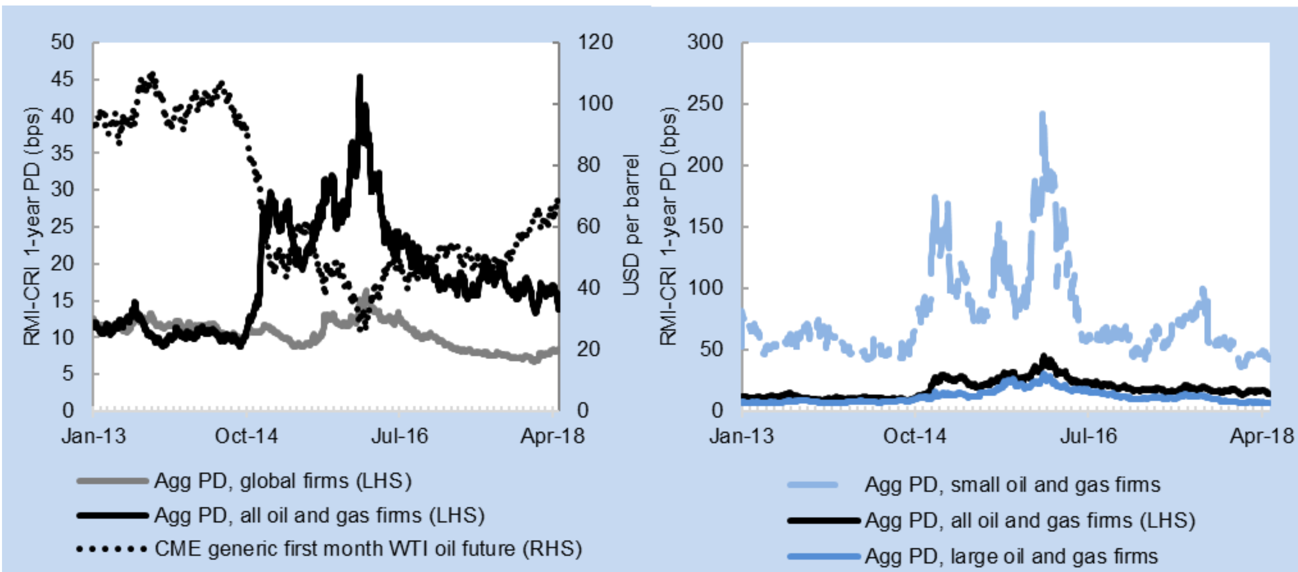
Default risk of small oil and gas firms remains high despite oil price recovery

by Dexter Tan

Oil and gas majors are reaping the benefits of higher oil prices as they reported increased profits and improved cash flows. Last week, Royal Dutch Shell posted a 42 percent rise in Q1 profit while Statoil ASA booked its best quarterly profit in four years. However, small oil and gas companies, or firms with market value of less than USD 200mn, have an elevated and more volatile credit risk than large oil firms (firms with a market cap larger than USD 1bn). Small companies have low cash flow and usually require continual injections of capital to sustain their operations. The RMI-CRI 1-year Aggregate Probability of Default (Agg PD) for small oil producers have declined recently but remained at a high level.



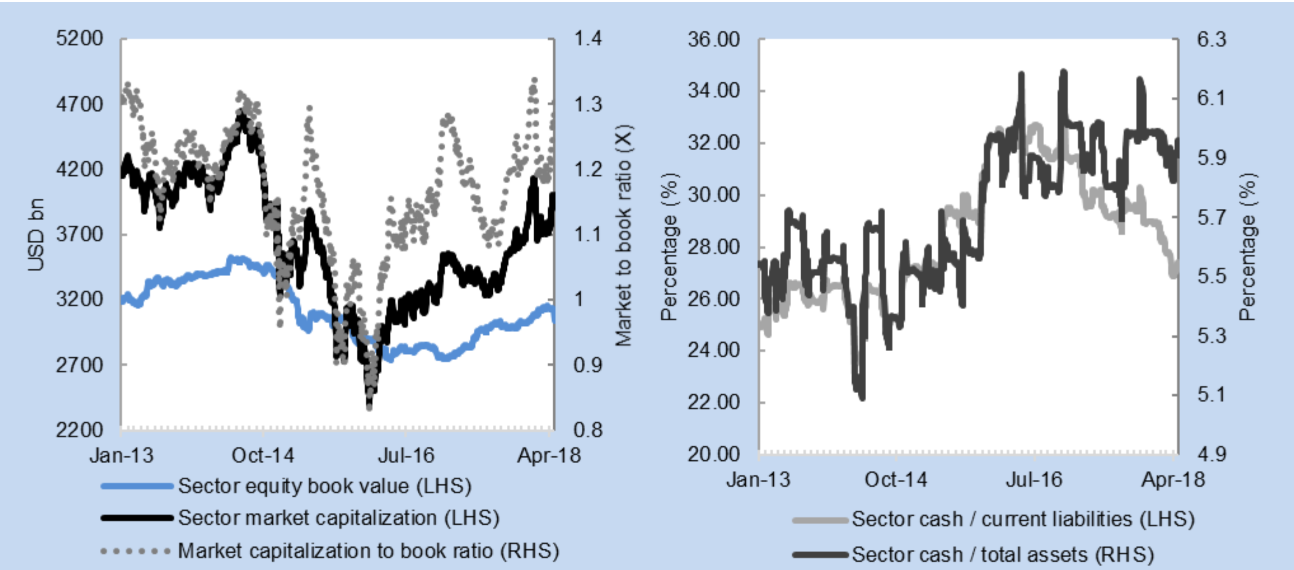
Figures 1a and 1b: West Texas Intermediate crude oil future, aggregate RMI-CRI 1-year aggregate PDs for global companies, large (market capitalization larger than USD 1bn) and small oil and gas firms (with a market capitalization of less than 200mn)

Excess capacity from non-OPEC countries, US shale production growth and decreased demand between 2014 and 2016 led to a sharp drop in crude oil prices from USD 110 per barrel to less than USD 40 per barrel. Highly leveraged oil producers defaulted on their debt obligations as depressed oil prices and limited financing sources forced them into bankruptcy. Large corporate defaults included Ultra Petroleum Corp and Energy XXI that listed USD 3.9bn and USD 2.9bn of debt in court filings. The RMI-CRI 1-year PDs for these firms soared to more than 4500 bps prior to their filing dates.

As oil prices began to fall, the RMI-CRI 1-year aggregate PD for 783 globally listed oil and gas firms exceeded the 1-year aggregate PD for all firms in October 2014 and continued rising over the following two years (see Figure 1a). Increased energy price volatility and changes in margins on refined products significantly affected the credit quality of oil producers. Upstream companies reported less revenues from lower commodity prices while higher production costs also significantly changed the credit quality of firms in the downstream and chemical segments.

The RMI-CRI 1-year default risk for small firms climbed from 103bp in December 2015 to 246bps in January 2016 and dropped back to 101bps by March 2016. Larger firms have a less risky profile than the sector's median aggregate credit profile but showed a similar deteriorating trend from 2014 till 2016. (See Figure 1b)

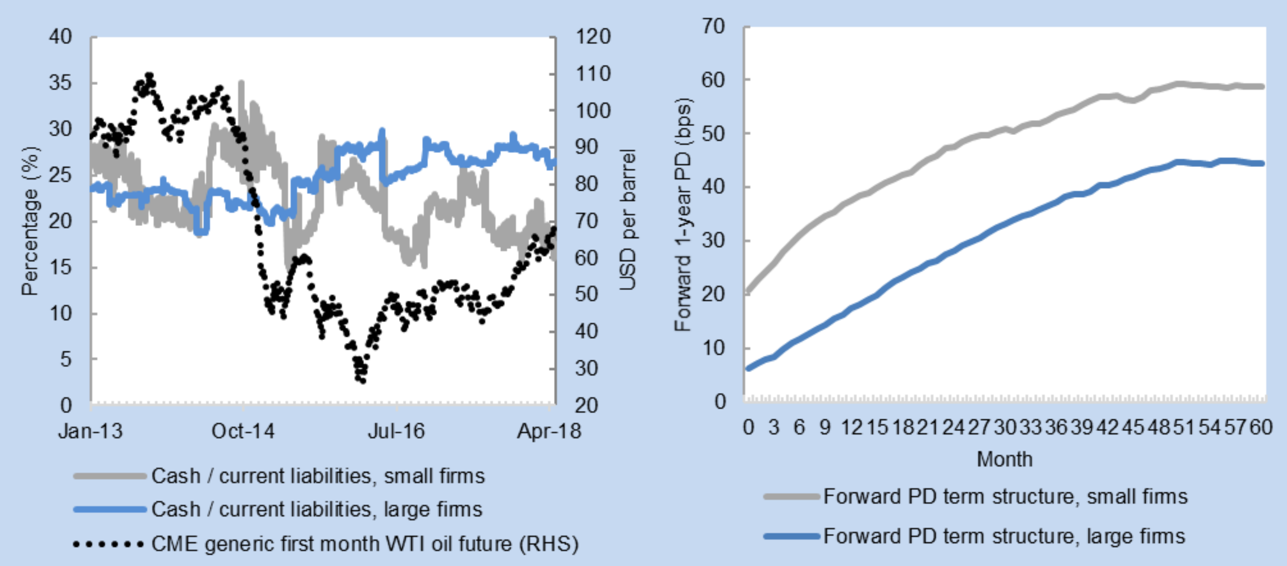
In the last two years, the rise in equity value has driven up the sector's valuation as the overall market capitalization may be on track to reach the July 2014 high of nearly USD 4.7tn. Oil and gas firms trade at an average market to book multiple of 1.3X, which is significantly higher than the 0.8X multiple in January 2016. Total equity book value climbed back to its highest level in 2.5 years of USD 3tn. In spite of the recent recovery in oil prices, oil producers have retained a higher percentage of cash on the balance sheet. The ratio of cash to total assets increased from an average of 5.5% between 2013 and 2016 to 5.9% after 2016.



Figures 2a and 2b: RMI-CRI adjusted market and book values of equity as well as liquidity ratios for the oil and gas industry between 2013 and 2018. Balance sheet variables have been adjusted to USD and formatted to a daily basis, taking on the value of the last reporting period. *Source: RMI-CRI, Bloomberg.*

However, the sector's liquidity is less appealing when cash is measured against current liabilities. The declining ratio of cash to current liabilities over the last two years suggests that more firms have a lower ability to service obligations or debts that are due within a year. A breakdown of the numbers in Figure 3a shows that small companies may be accounting for the drop in the sector's liquidity as there is a distinction between the cash proportions of large and small oil producers. The cash ratios of larger oil firms have improved to more than 26 percent of current liabilities as oil prices recovered from USD 40 per barrel to USD 68 per barrel.

The term structures of the RMI-CRI Forward 1-year Probabilities of Default (Forward PD) on Apr 27 indicates a weak credit outlook for the industry as most oil firms are likely to have a higher 1-year default risk (see Figure 3b). 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 6-month Forward 1- year PD is the probability that the firm defaults during the period from 6 months onwards to 1 year plus 6 months, conditional on the firm's survival in the next 6 months. The Forward PD term structures also imply that small companies have a higher future credit risk than large oil producers.



Figures 3a and 3b: RMI-CRI adjusted cash ratios and term structure of the Forward 1-year PD for the oil and gas industry on April 27. *Source: RMI-CRI, Bloomberg*

Global energy demand is projected to rise by about 25 percent from 2016 to 2040 and this demand increase is expected to be concentrated in developing countries. The long term success of the energy and petrochemical industries depends on complex long term capital intensive projects, which require a high degree of project management expertise to maximize efficiency. Beside oil prices, factors that can affect the firm's credit quality include the firms' ability to optimize the oil reservoir performance, negotiate successfully with joint ventures, governments, suppliers and customers, maintain peak operating conditions and mitigate risk of the firm's overall portfolio.

Credit News

State Bank of India plans recast of stressed power assets

Apr 30. India's largest lender, State Bank of India, is preparing for a major debt restructuring and takeover plan for stressed power plant assets, with loans adding up to INR 1.77tn and about 75,000 MW capacity. The bank has asked the power ministry to waive transmission penalties and grant early regulatory grant approvals to help new promoters. Furthermore, the bank has asked credit rating agencies to rate the debt of the stressed assets and value the plants as per rating at a sustainable debt portion. Power minister, RK Singh has also written a request to the finance minister, seeking an amendment on the mandate released on Feb 12. (Economic Times)

China's HNA reports debts have soared to USD 94bn

Apr 28. According to the 2017 annual report, the total debt of Chinese Conglomerate HNA has soared to USD 94bn, implying a greater extent on the firm's financial pressure behind its asset sales spree. The borrowing cost of the company's Shanghai-listed unit surged from USD 3bn to USD 5bn in the first half of 2017, exceeding its earnings before interest and taxes, despite increased net revenue and net income in 2017. HNA has weathered severe liquidity crisis in February with the help of some Chinese banks and its asset sales, while yields on some of its bonds soared to 20%. In March, the key subsidiary, Hainan Airlines claimed that it will take over HNA's stakes in two local airlines and other five businesses as part of the asset reorganization. (FT)

Barclays and Pimco to securitize GBP 5.3bn of UK mortgages

Apr 27. Barclays and Pimco are planning a securitization of GBP 5.3bn mortgages acquired from the UK Asset Resolution (UKAR). The mortgages originated from failed lenders Northern Rock and Bradford & Bingley, which UKAR purchased in 2010. The partial sale of the mortgages will allow UKAR to repay the remaining Financial Service Compensation Scheme loan. A consortium of banks made up of Barclays, HSBC, Lloyds, Nationwide, NatWest and Santander UK has committed to buying investment-grade bonds from the securitization. (FT)

Venezuela debt rally may falter despite oil price, election

Apr 27. Investors buying Venezuelan debt in recent weeks are on hopes that the May elections might bring a new government or that rising oil prices will bolster the OPEC member's creditworthiness. However, optimism for a potential regime change is misplaced. The regime in charge right now is unlikely to make the economic reforms necessary while the opposition is unable to fully combine separate political forces. Furthermore, Venezuelan oil production has shrunk a lot last year, which largely offset the benefit of rising oil price. OPEC data shows the production decline has continued through 2018. (Reuters)

A key decision on debt relief for Greece might not happen until June

Apr 27. Greece might not get the complete picture of its debt restructuring plan before June. The IMF and European creditors have different growth forecasts for Greece and have therefore been unable to set how much interest Greece need to pay on its loans. Failure to agree on debt relief plan would not only make Greece's return to the markets more abrupt but also compromise the credibility of providing financial assistance to European countries. The current deadlock over debt will not be resolved until June 20, when the finance ministers gather in Luxembourg for their monthly meeting. (CNBC)

GM again faces USD 1bn stock fight over bankruptcy accord (Bloomberg)

Saudi sets up committee on Saudi Oger debt restructuring (Reuters)

Disorderly Brexit poses risk to the UK's credit rating, agencies say (The National)

Regulatory Updates

Danish mortgage lenders told to stop whining about capital rules

Apr 30. Denmark's Financial Supervisory Authority (FSA) highlighted the need for mortgage lenders to address refinancing risks created by the use of short maturities bonds and bonds that were denominated in foreign currencies. This statement arises as the mortgage market is a huge part of Denmark's financial system and the outstanding bonds make up a large chunk of banks' liquid assets. FSA have made efforts to limit loan growth and steer banks away from issuing short-term bonds to fund 30-year loans. Based on the new Basel III capital standards, the total capital requirements required by lenders would push up by roughly a third, due mostly to the output floor. (Bloomberg)

China's central bank tightens rules on asset management firms in move to reduce risks

Apr 27. The People's Bank of China announced new rules for China's USD 15tn asset management sector with leverage limit and a bank on implicit guarantees as part of efforts to reduce financial risk. The total assets to net assets ratio will be capped at 140% for open-end mutual funds and 200% for closed-end and private funds. The regulations will start after the end of 2020. Financial institutions will also need to provision 10% of their commission income from asset management products as risk reserves and they cannot offer implicit guarantees on the asset management products. These rules were in addition to another that ban investors from pledging their shares in asset management products as collateral to obtain financing. (SCMP)

Basel tells big banks that simple might be better (Reuters)

China eases rules on foreign investment in securities firms (FT)

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Contributing Editor: Xu Zijun, Lisa