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Credit outlook for E&Ps remains weak despite 2019 oil price rally

by Liu Hanlei

The rally in crude oil prices since the start of the year was further boosted when the Trump administration announced that it will remove waivers from US sanctions on crude oil sold to some of Iran's largest customers, including China, India and Japan. The 35% rise in oil prices since Jan 2019 has enabled bond prices of US high yield energy issuers to rise, lodging a total return of 10.3% year to date, beating the broader high yield issuers according to indices run by Ice Data Services. The NUS-CRI 1-year Aggregate Probability of Default (Agg PD) of exploration and production oil and gas companies (E&Ps) fell to 28bps at the end of Apr 2019, after reaching a high of 39bps in Dec 2018.

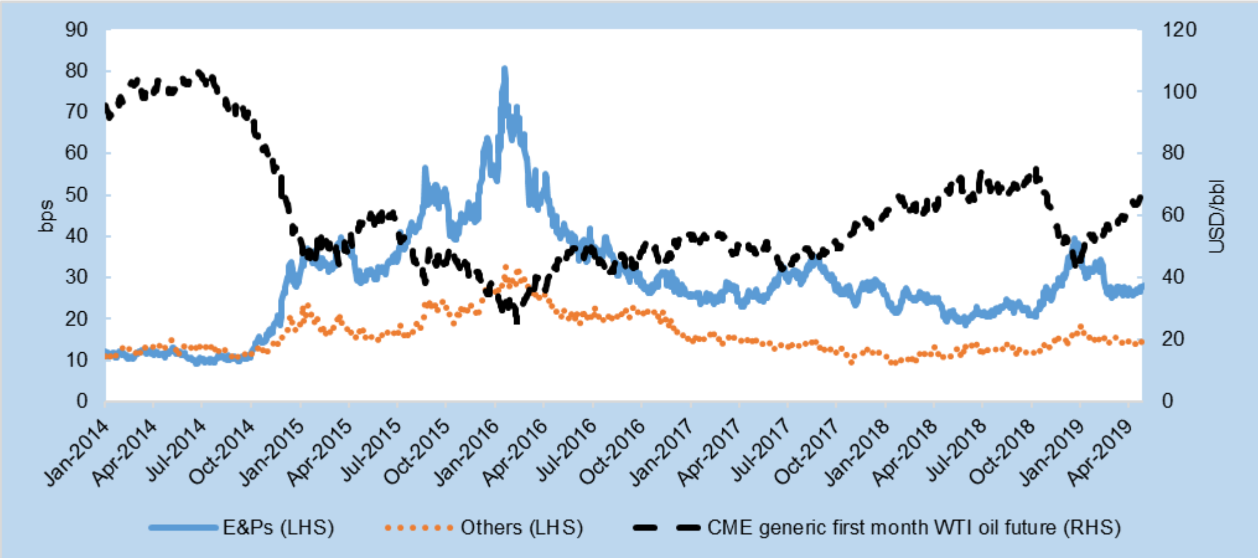

Figure1: NUS-CRI Aggregate 1-year PD for global E&Ps and others which include oil and gas companies that do refining, drilling and marketing, West Texas Intermediate crude oil future. *Source: NUS-CRI, Bloomberg*

E&Ps are some of the biggest beneficiaries of the run up in oil prices as they sell their oil and gas at the going market rate. In 2018, global publicly listed E&Ps managed to achieve a record high of USD 300bn free cash flow. However during times of low oil prices, E&Ps' cash flows may be impacted and could affect their ability to pay back short term obligations. During 2015-2016 when oil prices were in the doldrums due to oversupply issues, free cash flows for E&Ps fell below a record low of USD 50bn and the Agg PD for E&Ps reached a high of 80bps. Bankruptcy filings for E&Ps in the US also reached a record in 2016 with 114 companies amounting USD 74bn of debt. As seen in Figure 1, the Agg PD for E&Ps is more volatile and reactive to movement in oil prices as compared to other companies in the oil and gas sector that deal with refining, marketing and drilling. Despite the record cash flows in 2018, the oil market went through a volatile Q4 2018 and Q1 2019 and some E&Ps have filed for bankruptcy such as Jones Energy while others like Sanchez Energy have seen their bonds drop to record lows.

E&Ps are also more capital intensive as these companies need to invest to find and develop new oil and gas resources to replace the legacy wells. Despite amounting to approximately 25% of market capitalization of the whole oil and gas sector, E&Ps account for about 75% of financing needs with debt being the main source. In view of the current oil market trading in backwardation, when near-term contracts are more expensive than later contracts, E&Ps have utilised the run-up in oil prices up to Q3 2018 to pay down some of their debt to weather the potential weak oil prices ahead. Based on research from Rystad Energy, about USD 25bn, 8.5% of E&Ps' 2018 free cash flow, have been used to reduce debt. This is also reflected in the decreasing leverage ratio in the latest quarter as net debt to equity ratio for E&Ps fell from 69% in Q1 2018 to 51.7% in Q1 2019.

The weakness in oil futures market in the near term could be due to reports showing that US crude stockpiles have increased to their highest levels since 2017. US is the largest oil producing nation since Sep 2018 according to the US Energy Information Administration as it strives to be independent from foreign sources of oil. New pipelines connecting key production basins to export hubs on the Gulf Coast are also expected to be up by end of this year and in 2020 as President Trump signed executive orders in Apr 2019 to speed up construction of pipelines and projects. The executive orders are to enhance the production and transport of oil between states and across international borders which will connect the world's largest shale basin to the global oil market.

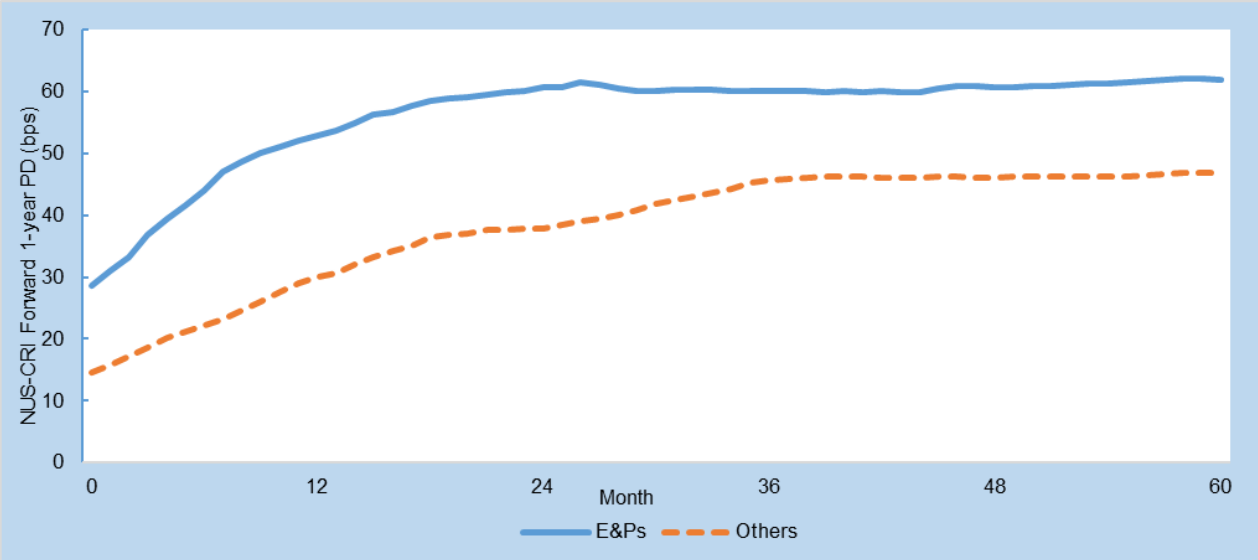

Figure 2: NUS-CRI Aggregate Forward 1-year PD term structure for global E&Ps and other oil and gas companies as of April 30, 2019. *Source: NUS-CRI*

In addition to deleveraging, E&Ps are taking a more conservative stance in their capital expenditure in 2019 amid the anticipated increase in supplies which results in the near term weakness in oil futures pricing. According to research by a US financial firm, E&Ps are expected to spend about 5% less in capital expenditure in 2019 as compared to 2018. From an oil demand perspective, various governments and international organizations have also downgraded expectations of economic growth for the near future amid disappointing economic indicators. The economic slowdown may depress demand for oil, giving further pressure to oil prices. Figure 2 shows the NUS-CRI Aggregate Forward 1-year Probability of Default (Forward PD) of the oil and gas sector, representing the credit risk of a company in a future period. For instance, 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 surviving the initial 6 months. Given the higher leverage and higher relation to oil prices, the difference in Forward PD between E&Ps and Others is widening in the near future amid weakness in oil futures pricing, signifying a worsening credit outlook for E&Ps.

Credit News

Thomas Cook's bonds tumble on fears over debt pile

May 4. UK based travel agency Thomas Cook has been hit with record sell-offs of its bonds and a credit rating downgrade last week as S&P Global lowered the company's credit quality to B-, its lowest level since 2013. Likewise, default insurance, namely credit default swaps, increased in price to a record high of 39% upfront. Thomas Cook had warned on profits in 2018 and announced plans to sell its unprofitable airline division in February 2019. Unconvinced by this plan, investors still fear an inability of the company to service its sizeable debt, with one lender recently selling a revolving credit line provided to Thomas Cook at only 59 pence on the pound. (FT)

Investors flock back to credit product blamed in financial crisis

May 3. A decade after the misuse of financial vehicles called asset backed securities (ABS), which are bundles of collateralised private home mortgages, a growing demand for a similar product has emerged. This time around, synthetic collateralised debt obligations (CDOs), bundles composed of derivatives using corporate loans as underlying, have seen between USD 50bn to 80bn of new issuance this year, according to bankers. Investors and bankers have argued that the chances of disaster for this asset class is much lower due to it being back by corporate debts. Clients include hedge funds and bond investors, are attracted by the higher returns in the midst of the current low-yield debt market. (FT)

Shadow lender crisis averted, says most valuable Indian bank

May 3. India's recently troubled financial markets have managed to stabilize but problems still exist, according to HDFC Bank's Managing Director Aditya Puri. After last year's defaults by Infrastructure Leasing & Financial Services, it shone a light on liquidity problems in the country's shadow banking sector, which currently accounts for about a third of newly issued loans. India's amount of non-performing loans (NPLs) is currently considered to be one of the worst in the world. However, the share of NPLs to total outstanding loans dropped from 10.8% in September to 10.3% in March, indicating progress on this front. Substantial improvements were achieved by changes in regulatory oversight and asset sales, Puri said. (Bloomberg)

Chinese tech companies revel in convertible-bond boom

May 2. 2019 has so far seen a boom of convertible bonds in China among tech companies, with almost USD 4.6bn having been raised. Netflix's competitor iQiyi, for example, after achieving an IPO of USD 2.4bn less than a year earlier, has sold convertible bonds of over USD 1.8bn. In exchange for a lower coupon rate, these convertible bonds can be exchanged for equity once a predetermined threshold in share price has been reached. This is appealing to tech firms, since they are able to easily finance their debt during their growth phase more cheaply and delay equity dilution until their potentially stronger later periods. (FT)

Companies in big refinance push while credit rally has legs

Apr 29. Some European companies are redeeming debt in advance despite higher repayment costs. The early redemption is because of the concern on the outlook of the market in the second half of this year. To be on the safe side, companies would rather pay back now than later which could be more expensive. Corporate bonds have lured investors amid dovish tones by central banks and yields of both speculative grade and investment grade corporate bonds have tumbled this year. The additional repayment costs also reflect how careful issuers have been regarding potential spread widening in the second half of the year and the strong demand from investors looking for yield. (Bloomberg)

Investors dive into high-quality US corporate debt once more (FT)

Boeing sells USD 4.8bn of bonds as 737 Max scrutiny deepens (Straits Times)

Bayer's credit rating under scrutiny as US legal woes mount (FT)

Regulatory Updates

China to impose stricter policy on bad-loan recognition

May 6. China's new major lenders are required to accelerate recognition of nonperforming corporate loans by classifying corporate loans overdue for more than 60 days as nonperforming, down from 90 days previously. China's regulators are working on keeping credit flowing in the face of US trade sanctions as well as making sure bad debts do not spiral out of control. The quicker recognition may help ensure banks make better lending decisions, but there are also concerns that the move could lead to a spike in non-performing loans. The move will increase non-performing loan balance by about CNY 50bn to 70bn, estimated by the chief banking analyst at Everbright Securities.(Bloomberg)

China steers credit to small firms in targeted reserve cut

May 6. The required reserve ratio for rural commercial lenders that serve local companies in the county where the bank operates or have less than CNY 10bn of assets will be lowered to 8%, down from 11% previously. The amount of cash released will increase lending to small and private firms as an expansion

of the targeted easing approach which seeks to lower the cost of loans for small and private companies while avoiding flooding the economy with liquidity. The cut will release CNY 280bn of long-term liquidity and about 1000 county-level rural commercial banks qualified for the reduction, according to the central bank. (Bloomberg)
ECB's Guindos says low bank profitability remains a concern (Bloomberg) **A series of non-events alters Fed rate-cut odds** (Bloomberg)

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