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The credit profile of Chinese renewables industry has improved unlike its US counterpart

by Wang Anyi

- **The NUS-CRI Agg 1-year PD demonstrates the improved credit profile of China's renewable energy industry over the past months amid strong government support, improved profitability, and lower leverage**
- **Meanwhile, the credit risk of the US renewable energy industry has heightened due to disruptions in supply chains, less policy support**

As the world moves towards carbon neutrality, renewable energy is increasingly coming into focus and was the only energy source for which demand increased in 2020. Hence, this week we shift our focus to the renewables industry[1] of the two biggest economies in the world, the United States and China. The NUS-CRI Aggregate (median) 1-year Probability of Default (PD) illustrates the reducing credit risk of China-domiciled renewable companies (Chinese renewables industry) on the back of continued government support and improving profitability. The PD for the Chinese renewables industry, which crossed the PDiR2.0[2] BB upper bound to peak in May 2021, has since progressively decreased and is now closer to the PDiR2.0 BB+ upper bound. In contrast, the PD of US-domiciled renewable companies (US renewables industry) has worsened since the start of 2021 due to weaker government support in the past and supply chain disruptions. Over the next 12 months, NUS-CRI Forward 1-year PD (Forward PD[3]) demonstrates that the credit risk of the US renewables industry is expected to soar above the PDiR2.0 BB upper bound, indicating potential headwinds ahead. In contrast, the credit profile of the Chinese renewables industry is expected to remain relatively stable, amid strong government support and stronger financials.

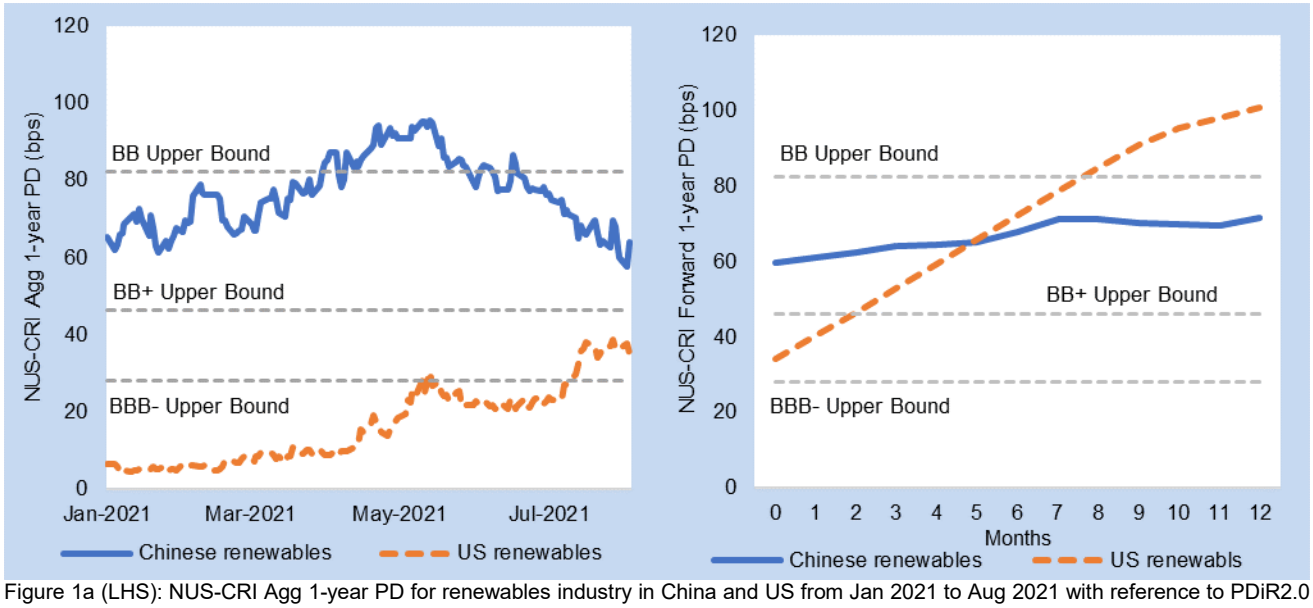

Figure 1a (LHS): NUS-CRI Agg 1-year PD for renewables industry in China and US from Jan 2021 to Aug 2021 with reference to PDiR2.0 bound. Figure 1b (RHS): NUS-CRI Agg Forward 1-year PD for the renewables industry in China and US over the next 12 months as of Aug 2021. *Source: NUS-CRI*

[1] The renewables industry includes companies producing or supplying energy from biomass, hydropower, geothermal, nuclear, wind, and solar energy as well as renewables equipment manufacturers.
[2] 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.
[3] 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 between the 6th month to the 18th month, conditional on the firm's survival in the first 6 months.

By the end of 2020, renewable power capacity constituted 42.4% of the total power capacity for China. To support the growing demand for renewable energy, the state-owned China Development Bank (CDB) has budgeted CNY 500bn to finance renewable energy projects over the next five years. Relying on the subsidies from the government in the past, renewables in China have developed rapidly and benefit from a lower cost of production with the leveraged cost of USD 41-62/MWh for onshore wind production and USD 29-59/MWh for solar production, compared to USD 50-66/MWh for coal-fired electricity. Furthermore, localized provincial policies aimed to facilitate renewable energy production are set to fill the gap brought by the phasing out of subsidies by the National Development Reform Commission (NDRC), ensuring continued sustainable development and support for onshore and offshore wind and solar. Additionally, the People's Bank of China (PBOC) has stated that financial institutions could make arrangements including loan extensions, renewals, and adjustments to payment terms for renewable companies facing short-term refinancing pressure.

China's President Xi has said that the country is going to become carbon neutral by 2060. As a result, the renewables industry is likely to face strong investor demand in the upcoming years, possibly aiding these companies in their access to capital. The Chinese renewable energy industry is currently considered a safe harbor with stable business performance and low regulatory risks. In comparison to the recent spate of crackdowns on industries, the Chinese renewable energy industry is considered policy-friendly in China, remaining unscathed amid the recent regulatory turmoil. As part of China's 14th five-year plan for 2021-2025 which proposes to increase the share of non-fossil energy consumption in 2025 by around 5 percentage points to 20%, China's renewables industry could expect continuous support from the government. For corporates, strong investor confidence may lead to easier access to funding and strengthening of companies' balance sheets, adding liquidity buffers and reducing potential refinancing risk.

In comparison, the policy support in the US is dwarfed by that in China. Despite the Biden administration's heavier emphasis on green energy transition, which may catalyze positive stakeholders sentiments, the renewables industry saw slowed growth amid the US government's retreating commitment to the renewables industry over the past few years. The remnants of these decisions can be witnessed today, as the electricity generation from renewables in China is more than double that in the US. In terms of solar, China owns an end-to-end supply chain and Chinese firms now supply three-quarters of the world's solar panels, while the US produces only 1% domestically. More importantly, China currently produces most of the world's polysilicon and solar cells which make them self-sufficient and indispensable in the supply chain, leaving the US vulnerable to supply chain shocks.

With the steady development of the renewables industry in China, the Chinese renewables industry has reported positive and stable earnings even during the pandemic (Figure 2a) and the ROA shows high YoY growth in the first quarter of this year. In contrast, a key challenge faced by the US renewables industry is unprofitability. Despite benefiting from lower leverage than their Chinese counterparts (Figure 2b), their ability to service debt, should they keep on experiencing negative ROAs, could be hindered.

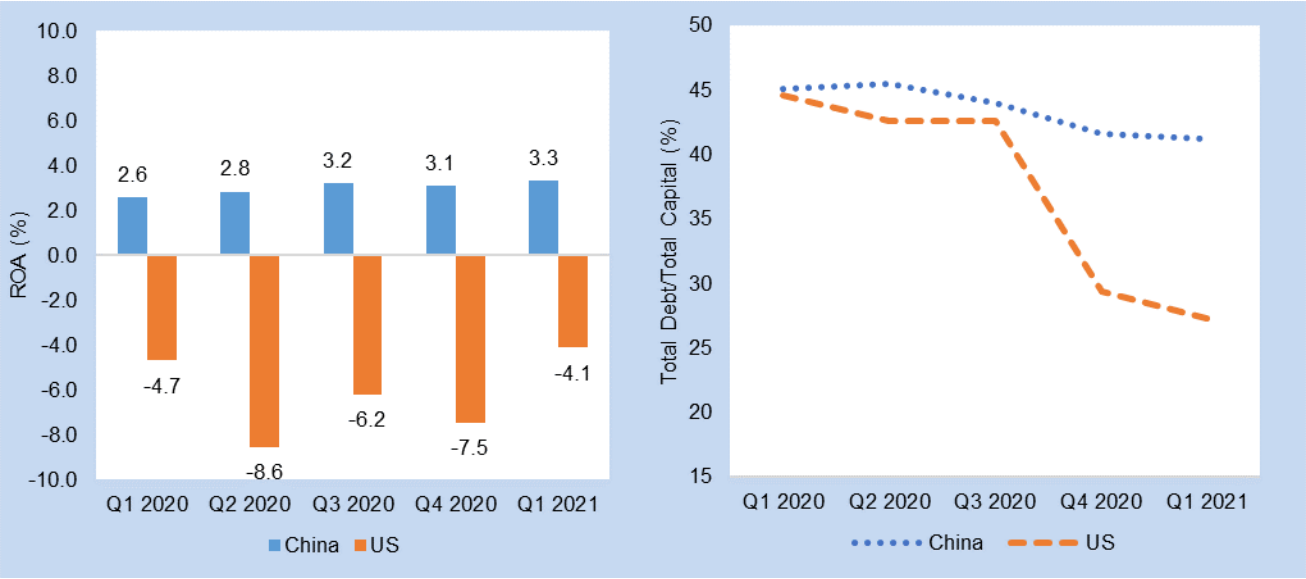

Figure 2a (LHS): Median ROA of renewables industry in China and US from Q1 2020 to Q1 2021. Figure 2b (RHS): Median Total Debt to Total Capital of renewables industry in China and US from Q1 2020 to Q1 2021. *Source: Bloomberg*

Rising costs and supply chain issues pose more challenges for the US renewables industry. This year, renewable energy developers continue to face rising costs for raw materials like copper and steel, metals that are used in wind turbines and solar panels. While the Chinese government managed to rein in the commodity prices, the problem of rising costs remains severe in the US. Transportation costs also tripled from a year ago as the world emerged from the global pandemic, hurting the US companies as they source most of their manufacturing materials or intermediate goods from China. Surging prices for key metals and higher shipping rates are going to continue to hurt US-domiciled renewable energy companies at least in the short term. Disruptions in supply chains have created further headwinds. In the first quarter of this year, shipping disruptions including the blockage of the Suez Canal have hindered the construction of projects. For example, First Solar, a panel manufacturer in the US, faced delays in its module shipments from Asia due to the port congestions. As the US continues to deal with coronavirus cases and hospitalizations, the US-domiciled renewables industry is facing potential supply chain disruptions and delays in project construction, directly influencing the commissioning of renewable electricity projects and thus dampening the cash flow generating capabilities of these companies.

Thus, while the US renewables industry could continue to suffer from persistent supply-side challenges, profitability issues, and the lagged effects of its past policy stance, the Chinese renewables industry is supported by tailwinds arising from government support that has placed it in good stead to continue benefiting from the positive investor sentiments. Specifically, China's control of the rare earth materials required in the clean energy transition means that supply shortages faced by the US renewables industry could drag on. Hence, it is important for the US to develop alternative sources of supply and reduce its dependence on China's renewable energy supply chains. Additionally, although the new US emissions reduction targets and the infrastructure bill will boost renewables expansion from 2022, the phasing down of the investment tax credit to 10% in 2022 from 30% previously in 2019 could increase the upfront expenses of US renewable companies moving forward. Unless these challenges are addressed, credit risks in the burgeoning renewables industry in these two economies could see a further divergence in the years to come.

Credit News

China's corporate crackdown adds to junk-bond distress

Aug 15. Following a series of debt defaults and possible regulatory crackdowns on the property sector, the Chinese high-yield bond market has seen average yields soaring to 14% in early August, making the yield gap between Chinese and American companies the widest in a decade. China Evergrande Group, China's largest junk-bond issuer, has recently faced financial troubles and has affected the junk-bond market as a whole. The recent average spread on Chinese bonds with B ratings at around 17% was wider than during the Covid-19 heights in China. Additionally, recent defaults by state-owned and private enterprises have pushed prices lower, but with investors' increasing hesitation with regards to recovery, the Chinese junk-bond market could get even cheaper. (WSJ)

More muni issuers are making banks compete to win bond deals

Aug 14. The issuance of long-term municipal bonds has increased to USD 64.6bn YTD, a 32% increase from the same period of 2020 and the highest for the year-to-date period since 2016. This rise in competitive deals signals the presence of strong demand in the market. Investors rushed to liquidity by pulling out from mutual funds last year. This year, however, the market has seen a great demand for tax-exempt debt diluting the want of excessive underwriting, leading to greater competition between banks. Furthermore, the supply of muni bonds predicted to be issued in the near term is short of the amount available for reinvestment by USD 14.9bn, up 10% from a year ago. Mutual Funds for tax-exempt bonds have also seen a rise in investment of around USD 60bn this year. This rise in demand in muni bonds may be driven by investors' hunt for yields during the current low interest-rate environment. (Bloomberg)

Chinese bond swings threaten global debt investors

Aug 10. Beijing's policy decisions are having an impact on Chinese corporate bonds, which are reverberating across global markets as money managers in the United States and Europe have piled into these securities. Chinese bonds are now so widely held that price swings are hitting even bond funds that do not specialize in developing nations. Global bond funds with the highest Chinese corporate debt trailed behind their benchmark indexes in the month that concluded last Thursday. The underperformance is linked to stock and bond falls in Chinese private education, technology, and real estate enterprises. Chinese authorities have announced plans to turn private education businesses into nonprofits and regulate technology companies. The administration has also indicated that it aims to limit real-estate developers' excessive borrowing as fears grew that China Evergrande Group might default on its bonds. More instability is expected to follow, especially for property companies with low credit ratings (WSJ)

Evergrande gets loan extensions from several major creditors

Aug 12. China Minsheng Banking Corp., China Zheshang Bank Co., and Shanghai Pudong Development Co. have agreed to give Evergrande extensions on some of its maturing project loans, with Zheshang Bank extending the maturities of two loans due in July and August till the end of 2021. These extensions would allow the property giant to hasten its asset sales and relieve pressures on its liquidity. Fears of a potential default have been mounting amid recent reports about wary creditors and unpaid suppliers, with banks displaying caution in offering new credit or renewing maturing loans to Evergrande. Over the past nine months, China Minsheng, one of the largest creditors to Evergrande, had cut its exposure to the company, supported by the developer's cash-raising from property sales. Last week, China's Supreme Court called for the centralization of all cases against the company, preventing local courts from freezing its assets at a single claimant's request. This would grant it more leeway to raise cash and ensure that its debt issues are resolved in an organized manner. (Bloomberg)

Covid-19 resurgence raises borrowing costs for travel-and-leisure companies

Aug 13. Following the rapid spread of the Covid-19 Delta variant, borrowing costs for leisure-and-travel companies have risen amidst higher risk. When issuing USD 1bn of new bonds, Royal Caribbean Group saw an increase of 125 basis points in yields on new five-year debt to 5.5% since July. Other high-yield bond issuers such as Cineworld Group PLC and AMC Entertainment Holdings Inc. also saw a drop in their loan

prices. Despite the climb in yields, bond yields remained below the level at pandemic heights in spring 2020. Companies are still borrowing heavily to repay their more expensive bonds because interest rates remain near record low levels. For now, without a rise in sales, leisure-and-travel companies should minimize their cost of capital to slow their cash burn. (WSJ)

China bonds face week of reckoning as loans, key data come due (Bloomberg)

Korean bank loans to households jump as BOK weighs rate hike (Bloomberg)

Fed reverse-repo facility usage jumps to record USD 1.087tn (Bloomberg)

Regulatory Updates

New Zealand expected to raise rates to cool overheating economy

Aug 16. New Zealand is expected to hike interest rates this week, as the country's strong recovery shows evidence of overheating. In July, Governor Adrian Orr abruptly terminated quantitative easing, indicating that the Reserve Bank of New Zealand (RBNZ) was already concerned about the risk of overheating. Since then, unemployment has dropped to 4%, with private wage growth reaching a 13-year high. The move on Wednesday might be the first in a series of rate hikes. Higher borrowing costs could relieve policymakers' pressure to rein in housing prices, which have risen 31% in the year to July. New Zealand's strict border policy has kept migrant workers out, resulting in labor shortages, and the economy is heating up as demand rises. However, a delayed vaccination roll-out in New Zealand has left it susceptible should the country get a resurgence in cases. Inflation jumped to 3.3% in the third quarter, above the RBNZ's 1-3% target for the first time since 2011. Inflation expectations have risen to a seven-year high. (Bloomberg)

Libor shift quickens in Singapore as contracts jump fourfold

Aug 13. Banks in Singapore embrace a new benchmark for derivatives transactions as the state prepares to transition away from LIBOR by the end of Sep-2021. The outstanding contract amount pegged to the Singapore Overnight Rate Average (SORA) jumped fourfold to USD 87.4bn in Jul from May. Comparatively, this still makes up a fraction of the USD 1tn products currently pegged to LIBOR. Singapore's migration has gathered steam as the deadlines for the discontinuation of legacy rates loom, and more products linked to SORA are launched, with the outstanding amount of the Monetary Authority of Singapore's floating-rate notes linked SORA soaring 20-fold to SGD 9.9bn in the past year. Singapore's dollar-based interest-rate derivatives continue to utilize SORA, and an orderly transition could help accelerate the growth of Singapore's derivatives market. (Bloomberg)

Tighter US bond market could dull pressure on Treasury prices from QE tapering (FT)

Fed's Kashkari Wants 'Few More' Strong Job Reports Before Taper (Bloomberg)

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Contributing Editors: Yao Xuan, Raghav Mathur