Outlook for Indian non-renewables improves despite challenges presented by renewable energy transition

by Amrita Parab

- **The NUS-CRI Agg PD of India's non-renewables industry elevated as declining demand caused by disrupted economic activity has resulted in depressed profit margins**
- **The NUS-CRI Forward PD showcases an improving outlook amidst expected increase in realizations driven by import substitution and as companies diversify into renewables business**

India is one of the largest consumers of energy in the world, making it a key stakeholder in the global energy landscape. Non-renewable resources such as coal (44%), oil (25%), and natural gas (6%) cumulatively meet 75% of India's total energy consumption needs. India's non-renewables industry is dominated by a few large state-owned companies which control the majority of the domestic market share. Although India has implemented several policy measures to achieve its sustainability commitments, non-renewables are set to continue dominating its energy market in the near and medium-term. The NUS-CRI Aggregate (market capitalization weighted average[1]) 1-year Probability of Default (Agg PD) of Indian non-renewables companies in Figure 1a below showcases an initial recovery in credit profile until Mar-2021, followed by deterioration from Apr-2021 onwards as the effects of the devastating second wave of COVID-19 hit the country for most of Q1 FY2022[2]. The non-renewables industry has had to deal with both lower access to capital as lenders further incorporate ESG-driven criteria, as well as declining demand, lower realizations, and disrupted operations caused by lockdowns, all of which pressured profit margins. In tandem, the industry has been facing a heightened Agg PD. However, the current NUS-CRI Agg Forward 1-year PD (Forward PD[3]) demonstrates an improvement, as well as divergence, in the outlook of non-renewables, when compared to Jan-2021 (See Figure 1b), which may be attributed to increased push and support by the government to move to cleaner technology and to diversify companies in the non-renewables industry into the renewables business. The improved outlook may also be attributed to domestic production substituting imports due to higher global oil, gas, and coal prices resulting in improved realizations for domestic players in the near term.

[1] Market capitalization weighted average Probability of Default is calculated as few large state-owned companies account for the majority of the industry's market share.
[2] In India, Financial year runs from April 1 to March 31 of the next year.
[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 during the period from 6 months onwards to 18 months, conditional on the firm's survival in the next 6 months. The Market Capitalization used for Forward PD weights are as of August 13, 2021.

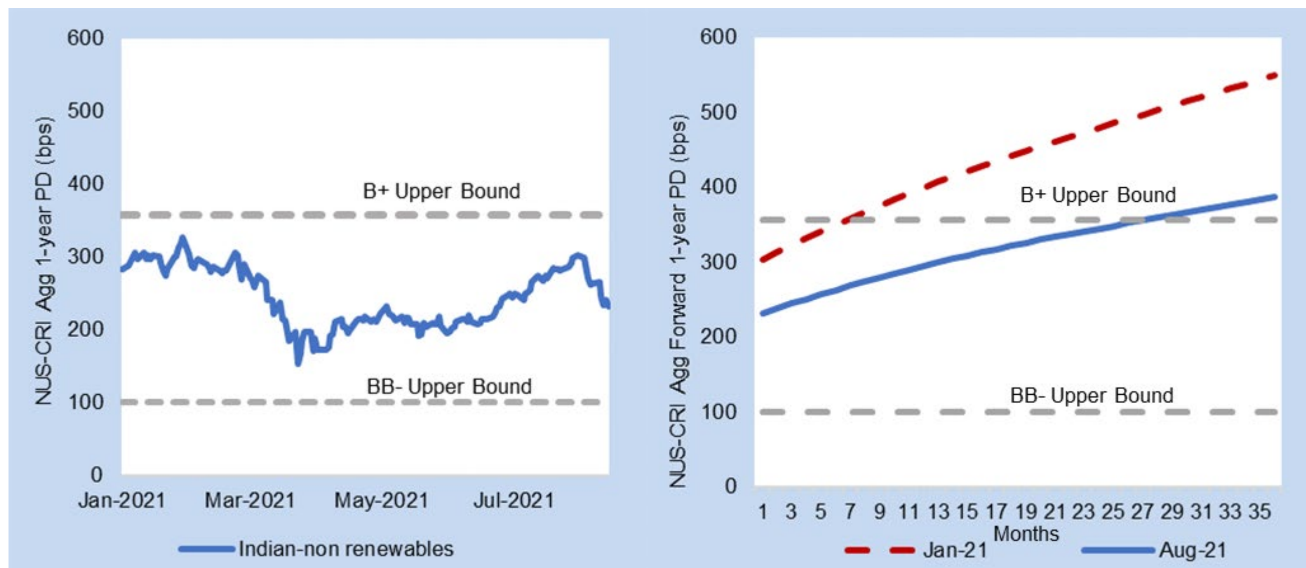

Figure 1a (LHS): NUS-CRI Agg 1-year PD for Indian non-renewables from Jan-2021 to Aug-2021 with reference to PDiR2.0[4] bound. Figure 1b (RHS): NUS-CRI Agg Forward 1-year PD for Indian non-renewables in Jan-2021 and Aug-2021 with reference to PDiR2.0 bounds. *Source: NUS-CRI*

One of the most significant headwinds faced by the coal industry is their weak access to financing, which may have contributed to the worsening credit quality (See Figure 1a). As banks adopt stricter ESG policies, bank credit to finance new coal projects is becoming increasingly difficult to obtain. Commercial and state-owned banks in India have remained averse to financing new coal projects as they try to appease investors and other stakeholders by avoiding investments in environmentally harmful projects. Furthermore, the second COVID-19 wave that hit India from Apr-2021 to May-2021 also hampered demand for coal as lockdowns reduced demand for power. Coupled with higher input costs, the depressed demand negatively impacted profit margins which may have worsened credit quality.

Credit risk in India's non-renewables industry has also been vulnerable to shocks in oil prices, especially as India's limited oil reserves have driven the nation to become one of the largest oil importers in the world. The recent rally in oil prices has caused India's crude oil import costs to surge by 190% to USD 24.7bn in Q1 FY2022 despite domestic fuel consumption in Q1 FY2022 being lower than pre-pandemic levels. The strong prices, coupled with a pandemic-driven reduction in demand, have hurt the refineries' profit margins. To alleviate the stress faced by refineries due to expensive imports, India has started selling oil from its Strategic Petroleum Reserve. It has also initiated a new round of oil and gas exploration auctions in a bid to reduce dependence on imports.

Although natural gas contributes only 6% to India's energy mix, the sector's credit risk could have growing significance to the credit profile of India's non-renewable industry. India has committed to increasing the percentage of natural gas in the energy mix to 15% as part of its effort towards decarbonization. Natural gas production registered a YoY growth of 19% in June, attributed to the commencement of production from deepwater gas projects operated by Reliance and BP. It is estimated that these projects will meet 25% of India's natural gas demand by 2025. As global cues push domestic prices higher, returns from natural gas projects are becoming increasingly attractive. The Indian government has also introduced policies to help increase domestic production of natural gas. One such set of policies was introduced by the National Gas Marketing Reforms in 2020 which afforded greater freedom to producers in the sale of natural gas through e-auctions. In addition, India's first automated gas trading platform was launched in 2020, ensuring more transparent transactions.

[4] 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.

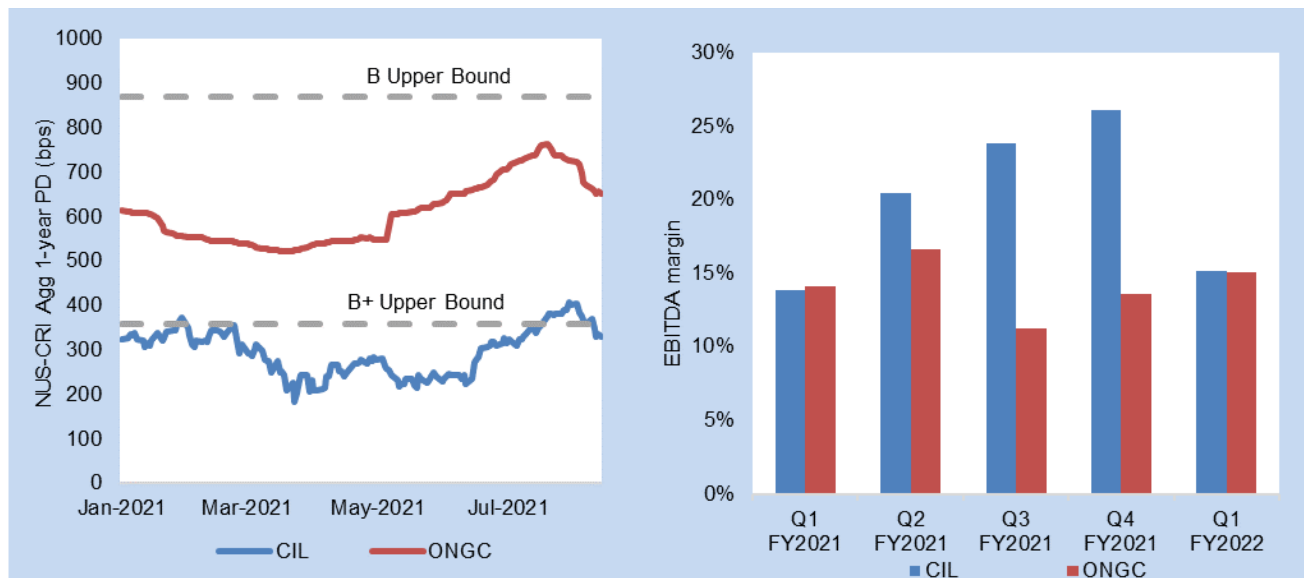

Figure 2a (LHS): NUS-CRI Agg 1-year PD for major Indian non-renewable companies Coal India Ltd (CIL), Oil and Natural Gas Corporation (ONGC) from Jan 2021 and Aug 2021 with reference to PDiR2.0 bounds. Figure 2b (RHS): EBITDA margin (%) of major Indian non-renewable companies - Coal India Ltd (CIL), Oil and Natural Gas Corporation (ONGC). *Source: NUS-CRI, Bloomberg*

India is the second-largest coal producer globally, with state-owned Coal India Limited (CIL) accounting for over 80% of total domestic coal production. The NUS-CRI PD of CIL (See Figure 2a) has shown an upward trend since Apr-2021, partially driven by the effects of the second wave of COVID-19. Q1 FY22 saw the company's EBITDA margin fall 11 percentage points to 15.18% QoQ. The average selling price (ASP)/ton fell by 3% QoQ as the declining demand for power resulted in higher inventory at power plants. However, going forward, higher international coal prices and domestic demand recovery may see the company realize a higher ASP/ton, possibly corresponding to stronger margins. The company is also aiming to reduce the impact of high expenses on its cash flows by replacing diesel-run machinery with the more efficient LNG-run machinery and reducing overhead costs. The company has also demonstrated signs of diversifying its operations by committing to invest USD 763mn by 2024 in sustainable energy projects aimed at making its mining operations more sustainable. Furthermore, Oil and Natural Gas Corporation (ONGC) is the largest crude oil and gas producer in India and accounts for 75% of the domestic production. The NUS-CRI PD of ONGC (See Figure 2a) remained stable for the majority of H1 2021. Despite a decrease in the production of crude oil and gas by 4.2% and 5.3% YoY due to the second COVID-19 wave, elevated global oil prices helped ONGC record a net profit margin of 5.3% in Q1 FY2022.

The transition towards more sustainable sources of energy poses a formidable challenge for the growth of companies in the non-renewable industry. With government push and technological advancements, the cheaper cost of adoption for renewable energy sources is making them more attractive over non-renewables. In India, the cost of solar-powered generation is now cheaper than that of coal-based power generation, incentivizing a transition towards renewables for power companies, which are the largest consumers of coal in India. For example, CIL has launched a renewables business by setting up two wholly-owned subsidiaries - CIL Solar PV Limited and CIL Navikarniya Urja Limited which will be involved in solar photovoltaic manufacturing and miscellaneous renewable projects. However, India's current high dependence on non-renewables means that the industry will continue to dominate India's energy market in the near future while navigating economic challenges and ESG-driven financing headwinds.

Credit News

Rating agencies caution on corporate debt after US borrowing frenzy

Aug 18. A surge in US corporate debt has laid the foundation for a wave of defaults at less creditworthy companies. The unprecedented wave of corporate fundraising, initially triggered by the Fed's corporate debt purchase scheme, has been further boosted by rampant investor appetite for high yields amid low interest rates, as well as the upswing in confidence after the announcement of successful vaccines. However, the potential for sustained higher inflation and slower-than-expected growth leave companies with floating-rate debt and upcoming debt maturities vulnerable to a jump in borrowing costs. Thus, while bankruptcies and corporate defaults are expected to remain low in the short term, analysts believe this easy access to financing might be laying the foundations for a future debt crisis. (FT)

South American local bonds are getting battered from all sides

Aug 20. Recent threats to the South American debt include inflation risks, rate hikes by the central bank, and fiscal issues, and concurrently, local currencies face potential devaluation following political concerns, the resurging Covid-19 Delta variant, and falling commodity prices. Peru's bonds have fallen 27% year-to-date, followed by Chile and Colombia at -20% and -16%, respectively. Increased government spending and inflation risks caused Brazil's central bank to hike rates by 3.25 percentage points to 5.25%. Other countries in the region that are facing similar problems are planning to follow suit even though growth rates have yet to reach pre-pandemic levels. In addition, political issues in Peru, Colombia, Brazil, and Chile have added to the increased volatility in the region, which may drive fixed-income investors out of the country. (Bloomberg)

First-time issuers help fuel junk bond rally

Aug 20. Investors looking for higher fixed-income returns are flocking to the lowest-rated junk notes issued by newcomers to the high-yield market. By the end of July, US companies sold nearly USD 316bn in junk bonds, 32% more than last year's total. Investors are still counting on a stimulus and vaccine-fueled economic revival in the United States. The Federal Reserve's policies have made the relatively higher yields on low-rated corporate debt more appealing to investors while allowing many companies to lower borrowing costs and refinance debt. Should an increase in Covid-19 cases delay the economy's reopening, analysts believe demand for higher-yielding debt is unlikely to wane, as ultralow interest rates, and record savings, have left many investors with few venues to earn better returns in the fixed-income markets. Some argue that junk bonds offer good returns despite growing inflation, which erodes bonds' fixed yields, and speculation that the Fed may slow its bond purchases, have brought short-term interest rates closer to a hike. (WSJ)

Cat-bond market rises to record with USD 8.5bn of issuance

Aug 18. The issuance of catastrophe bonds, which help raise capital for risks from natural disasters, reached a record of USD 8.5bn in H1 2021. The issuance of insurance-linked securities for the full year may exceed USD 10bn. The market was hot as investors re-invest more money as older securities matured, coupled with the diversification effects of adding such assets. As investors seek unique assets, it has been increasingly popular in recent years. Some of the bonds issued in H1 covered risks including earthquakes in California, as well as windstorms and wildfires. The risk arising from the ongoing pandemic may make these types of bonds more attractive. Although securities have previously covered such a risk in the market, reinsurers are "optimistic" about the growth of these securities over the next few years (Bloomberg)

Leases to Facebook, Netflix boost confidence in property bonds

Aug 20. This week, two new commercial mortgage-backed securities (CMBS) with a combined value of USD 1.305bn were issued by a subsidiary of Brookfield Asset Management and a partnership between Blackstone and Hudson Pacific Properties. Leases to Silicon Valley firms and other quality media brands backed these securities, with the two main tenants being Facebook Inc. and Netflix, which increased the attractiveness of the investment amidst a period of low interest rates. Risk premiums on CMBS fell to 65bps over the 1-month Libor from 70 to 75bps, reflecting the increasing investor demand for these securities.

Furthermore, the CMBS sector this year has been consistently backed by high-quality real estate, which is expected to continue holding value even amidst macroeconomic uncertainties. (Bloomberg)

High-Grade bond supply slows to USD 5bn amid August lull (Bloomberg)

China Huarong's bonds jump on state-backed rescue (Reuters)

Baidu sells USD 1bn of bonds amid china tech crackdown (Bloomberg)

Regulatory Updates

Bond market clashes with hawkish Bank of Korea over rate pricing

Aug 23. Bond investors in South Korea appear to be betting against the central bank. As the rising cases raise the likelihood of an economic shutdown, swap markets have lowered the probabilities of future Bank of Korea (BOK) interest rate increases. Governor of BOK indicated in July that even two hikes would leave policy accommodating, indicating potential tightening. While the BOK kept its benchmark rate at a record low of 0.5% last month, some argued for a quarter-point increase. Anxiety about reining in rising family debt, a property bubble, and other financial imbalances are among the causes for hawkishness. If the central bank raises its policy rate to pre-pandemic levels of 1.25%, Korean shorter-maturity bonds will suffer. Bond investors, however, are skeptical that the BOK would be able to follow through on a series of rate hikes that would push yields higher. (Bloomberg)

Kaplan open to shifting view on taper if delta curbs recovery

Aug 13. Robert Kaplan, chairperson of Dallas Fed, is willing to adjust his view that the Fed should begin the asset-buying program as soon as possible if the delta variant persists and slows economic activities. The Fed is now buying USD 80bn in Treasuries and USD 40bn in mortgage-backed securities every month. Kaplan has stated that he supports gradually reducing such purchases from October. Last month, most Fed officials agreed to slow the pace of bond purchases nearing the end of this year. As COVID-19 cases have surged nationwide due to the delta variant, there is one month to watch how the economic activity will unfold before the next meeting of Fed officials on September 21-22. As for how effective the purchases are in improving workers' ability to find jobs remains unknown at this stage. (Bloomberg)

Indonesia's central bank keeps rates at record lows, prepares for U.S. tapering (Reuters)

Sri Lanka becomes first in Asia to tighten policy in pandemic-era (Reuters)

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