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Weekly Credit Brief Dec 04 - Dec 10

Oil industry in a relatively stronger credit profile as compared to 2015 despite recent oil price volatility

By Zheng Chencheng

A collapse in global oil prices extended and have fallen almost a third since October despite OPEC and Russia tentatively agreeing some form of production cut. The US West Texas Intermediate was at USD 52.61/barrel by 7 Dec, after earlier falling as low as USD 49.65. Brent was at USD 61.40/barrel by 7 Dec, after earlier falling as low as USD 57.50. A slowdown in oil demand is compounding the market worries of oversupply amid concerns of a slowdown in the global economy and the roiling trade tensions. The credit profile of companies in oil industry, tracked by the RMI-CRI 1-year Aggregate Probability of Default (Agg PD) increased to its highest level from January 2017, reflecting the concern of the volatile oil price.

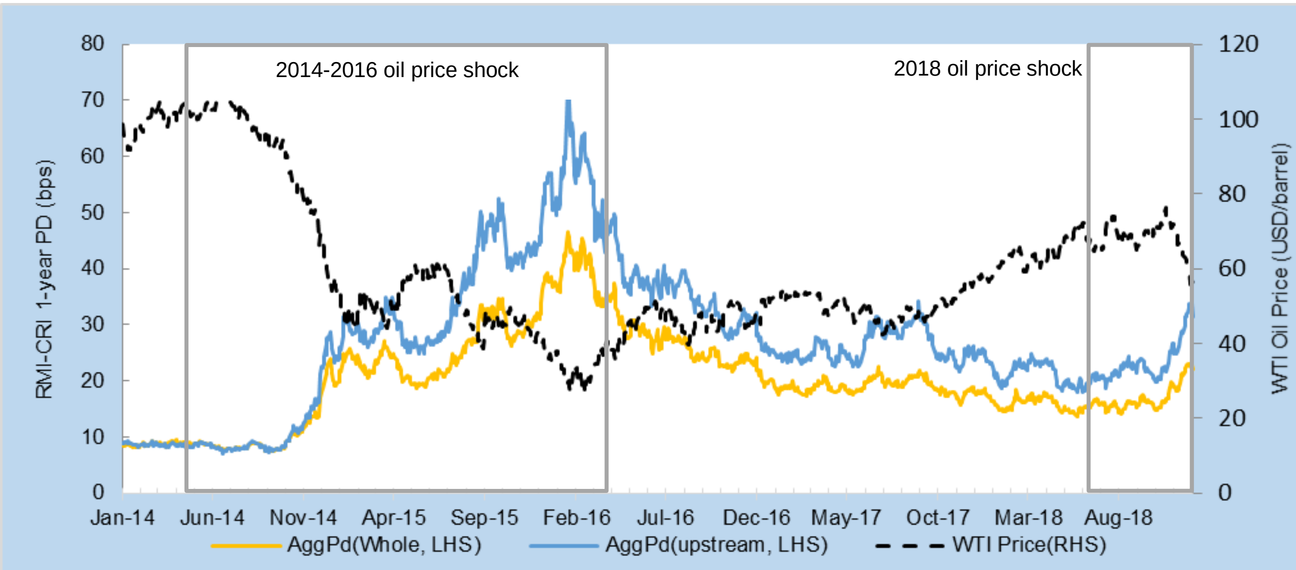

Figure 1. RMI-CRI 1-year Aggregate PDs for Global Oil Industry and WTI Oil Price. *Source: RMI-CRI, Bloomberg*

Exploration and production (E&P) also known as upstream companies tend to be riskier than the general oil industry. This is represented historically in the RMI-CRI 1-year Agg PD after Nov-14 when the Agg PD for the upstream industry is higher than the whole oil industry. The volatility of the oil market has affected some bonds of E&P companies. Some high yield energy issuers are reintroduced to the distressed debt market after 30% plunge in oil prices since October 2018. Bonds issued by Weatherford, Sanchez Energy, EP Energy, California Resources, Denbury Resources and Parker Drilling have lost more than 15% in past two months. They're now trading with credit spread of more than 1000 bps. Weatherford bonds have lost over 30% while Parker Drilling notes have lost about 25%. Debt issued by offshore drillers Ensco, Transocean, Noble Corp. and Diamond Offshore has lost about 15%. North American midstream stocks are also struggling, amid waning investor confidence that drove the Alerian MLP Index, which is the popular gauge of energy infrastructure Master Limited Partnerships (MLPs) another 12% lower through 7 Dec.

This may remind us of the oil price shock between 2014 and 2016, when excess capacity from non-OPEC producing countries, US shale production growth coincided with the decrease in demand. Oil prices then halve between June 2014 and March 2015, with the main fall after September 2014, from USD 110/barrel to less than USD 40/barrel. Highly leveraged oil producers defaulted on their debt obligations as depressed oil prices and limited financing sources forced them into bankruptcy. In 2015 alone, 42 oil companies filed bankruptcy proceedings, according to law firm Haynes and Boone. Total secured and unsecured energy sector debt moved into bankruptcy stood at a USD 13.1bn. Large corporate defaults included Ultra Petroleum Corp and Energy XXI that listed USD 3.9bn and USD 2.9bn of debt in court filings, both with RMI-CRI 1-year Probability of Default over 1500bps by the end of 2015.

But the credit profile of the oil industry is currently different today due to better fundamentals relatively to the oil crisis in 2015, especially for E&P companies. Improved drilling techniques, cost cuts and lower debt leverage have put oil producers in a stronger position than 2015 to weather the current drop in WTI crude to about USD 50/barrel. Drilling, fracking and management improvements have resulted in significantly lower cost profiles. Based on Bloomberg estimation, Nymex oil cash cost dropped from USD 70 to USD 55/barrel in 2018. Lower production cost gives E&P companies a larger margin of safety. As for midstream companies, Midstream companies are better positioned due to limited direct exposure to commodity prices as well as a recent wave of mergers and dividend cut.

	Total Debt/Capital (%)		Cash Ratio (x)	
	4Q 2015	3Q 2018	4Q 2015	3Q 2018
BI North America Independent E&Ps Valuation Peers	91.89	53.92	0.4	0.29
North Sea-focused E&P	66.7	54.9	0.2	0.3
OECD Europe-based Integrates	35.1	33.9	0.4	0.5
Russia-based Integrates	34.9	21.9	0.5	0.4
BI China Oils E&P Competitive Peers	28.7	23.6	0.2	0.4

Table 1: Debt ratio and cash ratio for different valuation peers in 2015 and 2018. *Source: Bloomberg.*

Following a desperate experience during 2014 and 2016, many companies have focused on strengthening balance sheets in the past two years. Many independent oil and gas producers have been primarily focused on paying down debt and reducing leverage over the past 24 months. Bloomberg Intelligence North America Independent E&Ps Valuation Peers had the largest debt ratio improvement, from 91.89% on 4Q 2015 to 53.92% on 3Q 2018. Liquidity improvement is also seen in other valuation peers such as North Sea-focus E&P peers and OECD-based oil and gas companies with higher cash ratio. Though average oil prices over the past year is lower today than the 1-year period in mid-2015, leverage among many producers is lower. Together with the lower oil cash cost, the aggregate PD for the whole oil industry is presently lower than in the 2015 period.

OPEC's divisiveness and geopolitical tensions are likely to increase crude price volatility. While producers are in much better shape to handle a bear market in oil prices today than in 2014-2015 period, the sector as a whole may need Nymex oil prices north of USD 50/barrel to sustain long-term growth. Volatile basis differentials, the difference between the futures price and spot price, and the inclusion of natural gas in their production mix increase their long-term barrel of oil equivalent price hurdle. The other doubt is whether the global economy will remain strong to sustain the oil demand. And the key to the global economic outlook will be whether the United States and China can resolve their trade disputes. Washington and Beijing announced a 90-day truce on 2 Dec, during which neither side will further increase punitive import tariffs. If global economy stays strong, then cost deflation should help oil producers in their profitability.

Credit News

Australian home loans jump as RBA sticks to rate hike call

Dec 10. The Reserve Bank of Australia continue to hold the cash rate at a record low of 1.50% since August 2016. RBA however emphasized that the next move will likely to be an increase as there are expectations that inflation will accelerate gradually. RBA remained upbeat about the overall domestic outlook and is relieved that data from housing finance approvals in October showed a surprising jump as stabilization of the housing market is key. Australia's property market is now in a downturn after regulators take steps to curb risky lending after prices in Sydney and Melbourne doubled between 2008 and 2016. The downturn in the property market is seen as the biggest risk to Australia's economy which is in its 28th year of growth without a recession. (Business Times)

US consumer credit rose most in 11 months in October

Dec 8. Federal Reserve figures showed that US consumer debt rose by the most in almost a year, which increased by USD 25.4 billion from the prior month and topped the median estimate of economists for a USD 15 billion increase. Revolving credit outstanding including credit card debt and non-revolving debt outstanding including loans for education and automobiles saw a climbing trend, indicating Americans were borrowing more to finance purchases even as the Fed is on track to raise borrowing costs in December. Besides, the strong job market and lower taxes are helping households to keep spending**.** (Business Times)

'Brexit premium' driving up euro borrowing costs for UK firms

Dec 7. The gap between British firms' bond yields and that of their European counterparts has surged to the widest in years, indicating that British firms are facing higher borrowing cost on the international bond markets amid Brexit uncertainties. The analyses conducted by NIESR showed that a 'no-deal' Brexit can potentially leave Britain's economy 5.5% smaller by 2030 than under the EU membership. While Bank of England surmised that the 'no-deal' Brexit will hit Britain's economy harder than the 2008-2009 financial crisis which might have caused anxious investors to apply a 'Brexit premium' on British firms that are particularly exposed to the British economy. Even if UK's Prime Minister Theresa May's Brexit deal is approved, British firms will still face a higher borrowing cost compared to their European peers as it will still leave Britain's economy smaller than under the EU. (Business Times)

Italian companies and banks cut back bond sales

Dec 5. Italian companies and banks are on track to sell the smallest amount of debt in a year since the financial crisis, underlining how troubles in the country's sovereign bonds have rippled out across the private sector. To date, companies and banks domiciled in Italy have sold USD 77bn of bonds in 2018, the lowest amount raised in the first 11 months of the year since 2008. Last month, The Bank of Italy reported that the value of Italian banks' outstanding bonds fell 17% in the year to September and net issuance of subordinated debt hit its lowest level in five years in the second quarter of 2018, and yet they have to face a EUR 110bn maturing debt in the next two years. S&P also warned that the continued budget battle between Brussels and Rome could result in higher funding costs for the private sector. (FT)

Thomas Cook debt-holders scramble for protection against default

Dec 4. The cost of insuring credit default swap (CDS) on Thomas Cook's debt hit a record high and the company's bonds tumbled last week. The company cut its profit guidance and suspended its dividend last week, blaming an unfavorable weather this summer in northern Europe. The CDS spread implied a probability of default of 60% and S&P cut its outlook on the company's credit rating to "negative" from "stable", stating that its leverage - debt-to-core earnings (EBITDA) - was too high at 5.9 times. As Thomas Cook also owns an airline business, there are worries over further possible airline collapses like Air Berlin and Monarch in 2017 as oil price rises. (Today)

Interserve confirms talks with lenders on deleveraging plan (Bloomberg)

Noble facing insolvency after new share listing is blocked (FT)

China to encourage some "zombie" firms to restructure (Business Times)

Regulatory Updates

BoE ready to loosen bank 'rainy-day' buffers on Brexit upheaval

Dec 5. The Bank of England would allow banks to use 'rainy day' funds in an attempt to maintain the lending to the wider economy should UK suffer market disruption after Brexit. The funds, known as the counter-cyclical buffer, forcing banks to hold more capital in good times to use in times of economic downturn, is currently set at 1 per cent of banks' total assets when adjusted for risk. And a cut to 0 per cent would enable banks to absorb up to GBP 11bn of losses, and to lend as much as GBP 250bn to UK households in businesses. The move is the latest sign that the Bank of England is preparing the British economy for the worst-case scenarios under a disorderly exit from the EU. (FT)

EU strikes deal on bank reform, few technical details remain

Dec 4. European Union finance ministers struck a deal on a major reform of banking rules to address some of the loopholes exposed by the global financial crisis. Under the reform, European banks will have to abide by a new set of requirements to keep the lending in check and to ensure that they have stable funding sources. In addition, EU lenders will be required to hold a 3% leverage ratio to increase their financial stability and meet a funding ratio aimed at limiting reliance on the type of short-term financing that contributed to the crisis. (Reuters)

India central bank keeps rates on hold, moves to spur lending (Reuters)

All around the world, central bank independence is under threat (Bloomberg)

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