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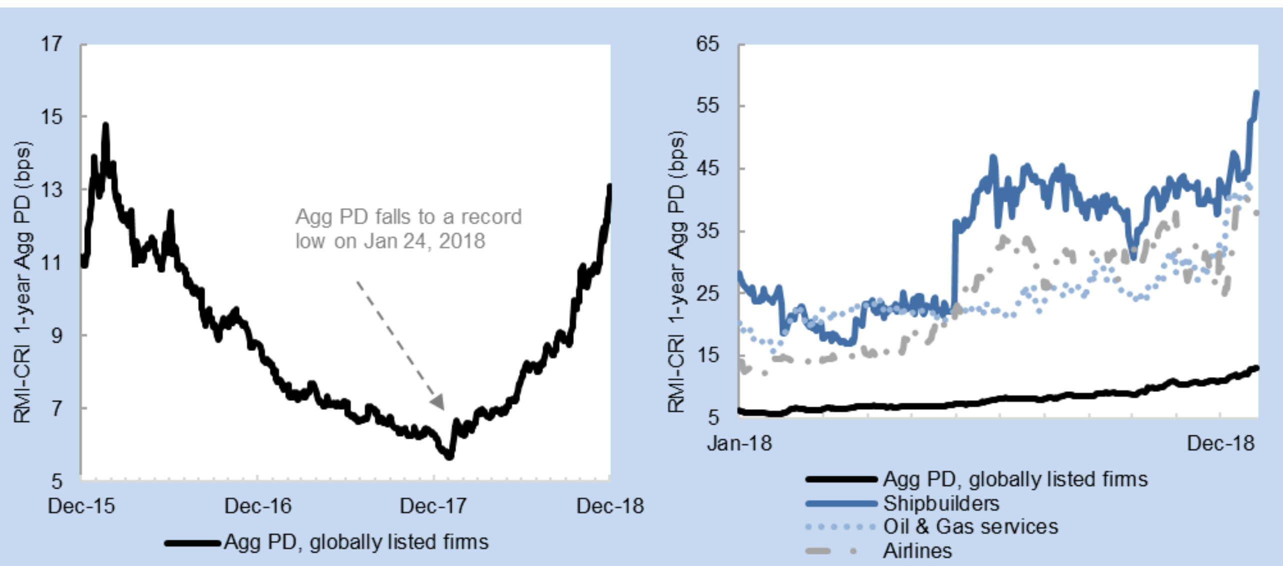
Credit profiles of globally listed firms end 2018 on multi-year lows

by Dexter Tan

Global credit outlooks have deteriorated and are looking more negative than at the start of the year across most sectors. The worsened outlook for global credit quality is underpinned by higher funding costs, a slowing global economy, trade tensions between the largest countries and elevated geopolitical risks among others. Looking ahead, credit market conditions could remain volatile and a sharp slowdown in economic growth is likely in 2019. These concerns were reflected in the default risks for publicly listed companies, tracked by the RMI-CRI aggregate 1-year Probability of Default (Agg PD) in Figure 1a.

In the current tumultuous financial market environment, the number of global corporate defaults are expected to increase over the next twelve months. The RMI-CRI 1-year Agg PD for 42212 listed firms dropped to a record low on January 24 before climbing significantly in the last three quarters of 2018, reversing two years of declines since its high in December 2015. Lower revenue growth and higher fiscal corporate tax burden weighed on company earnings and possibly placed upward pressure on the company's aggregate corporate credit risk profile.



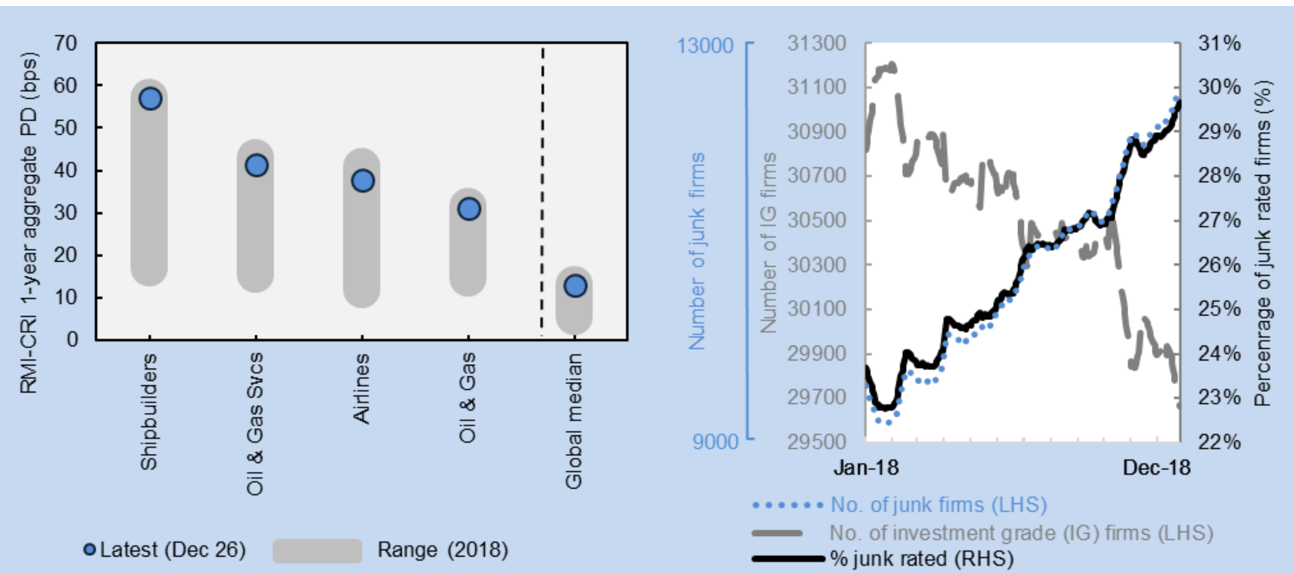
Figures 1a & 1b: RMI-CRI 1-year Agg PD for globally listed firms and RMI-CRI 1-year Agg PDs for sectors with the highest default risks. *Source: RMI-CRI*

Weakening funding conditions and higher bond yields also posed challenges to corporate borrowers, particularly firms with substantial debt leverage. With more than USD 1.2tn of debt maturing in 2019, much of which was issued when interest rates were low, companies will have to decide whether to repay bond principals or refinance at a higher cost. Stricter macro-prudential measures implemented in some countries such as tighter lending requirements and increased capital outlays could exacerbate corporate credit risks.

From a geopolitical standpoint, 2019 offers an array of challenges that could affect corporate credit quality. First, trade tension between China and the US: After achieving some improvement in trade terms with South Korea, Canada and Mexico, market observers wonder if the US will end up settling for some minor adjustments in trade with China by early 2019. Ongoing negotiations could fundamentally shift the balance of future economic power, in which case escalating tensions should be expected; the result eventually will have large implications on the credit risks of firms operating in the US and China.

Second, turmoil in the Middle East: analysts question if the long running regional conflicts between Saudi Arabia and Qatar as well as Saudis and Iran would ever end, even as the US announces its withdrawal out of Syria. Finally, Brexit and the rise of populism in Europe: with the March 29 departure date fast approaching, the impact on UK corporate credit profiles hinges on Theresa May's deal through Parliament, if it results in an orderly departure, or, a crash out of the EU with no deal. Risks elsewhere in Europe remain elevated too. French President Macron's approval ratings had dropped below 20 percent and the disputes between Brussels and Italy's populist government continues.

So far, the worst sectors in credit quality are firms in shipbuilding, airlines and oil & gas with the highest default risks and poor credit fundamentals. The aggregate 1-year PDs for these sectors, as shown in Figures 1b and 2a, have increased significantly during 2018. Sector constituents like Hanjin Heavy Industries & Construction posted lower earnings and declining market capitalizations, resulting in a sale of key assets and job cuts to reduce operating expenses. Wild swings in oil prices also roiled the credit outlooks of oil and gas firms as concerns of an oversupplied market and waning Chinese oil demand caused oil prices to slide towards the end of the year. Weatherford International plc and Eco-Stim Energy Solutions Inc. are among firms most likely to default by the end of 2019, with RMI-CRI 1-year default probabilities exceeding 50 percent on December 26.



Figures 2a & 2b: RMI-CRI 1-year Agg PD for globally listed firms and RMI-CRI 1-year Agg PDs for sectors with the highest default risks. *Source: RMI-CRI*

The number of speculative-grade, or junk companies (rated BB negative and lower) following RMI-CRI Probability of Default Implied Ratings, increased to 12518 in December from 8138 a year earlier. The number of speculative-grade companies continued to climb in the second-half of 2018 as the number of downgrades more than offset the number of upgrades, defaults and other exits. The RMI-CRI Probability of Default Implied Rating (PDiR) provides a more conventional interpretation of PDs – it translates RMI-CRI 1-year PDs to letter ratings by taking reference from the historical observed default rates of Standard & Poor's (S&P) rating categories. The number of companies rated BB negative and lower as a percentage of all rated companies moved above its 250-day moving average of 25.9%, ending at 29.6% in December 2018.

Looking at a Bloomberg poll of fund managers for 2019, experts predict heightened market volatility and low returns across all asset classes. According to them, a weak macro-environment, falling revenues, tighter monetary policies, reduced liquidity and increased attention to trade-related developments could set the tone for markets in 2019. Compared to the starts of previous years, fund managers are far less bullish on asset classes heading into the new year, which is to be expected as company market capitalizations have had one of the longest bull market on record in 2018.

Credit News

Asian debt defaults expected to rise

Dec 28. As weakening currencies and tighter liquidity leave riskier borrowers with higher refinancing costs, Asian debt defaults are expected to rise in 2019. Bloomberg-compiled data show that Asian dollar bond market defaults tripled to at least nine in 2018 from the previous year. These rising failures make governments harder to navigate during a politically fraught 2019, with elections in India and Indonesia. In India, a landmark default by shadow lender Infrastructure Leasing and Financial Services has tightened liquidity for non-bank lenders, while China's deleveraging campaign and push to cut the number of zombie companies have prompted more failures. Mounting non-payments may sour sentiment in the credit market, which, however, could boost business for investors in problem assets. (Straits Times)

Sears may be down to its last 24h, iconic retailer on the verge of liquidation

Dec 28. Sears may liquidate its business if its Chairman, Eddie Lampert fails to meet the deadline to submit his offer. After applying for bankruptcy on Oct 15, Sears' last shot at survival is a USD 4.6bn proposal put forward by Lampert. In his five-year tenure as CEO, Lampert poured millions of dollars through his hedge fund, ESL investments, into Sears which struggled for years with losses and debt. After Sears filed for bankruptcy, Lampert has had less control over Sears. Without financing in place, ESL missed its chance to be named a so-called stalking horse bidder in an auction for Sears earlier this month, which is a sign of the challenges Lampert faced. (CNBC)

Argentina bonds are losing even after a record IMF bailout

Dec 27. Bondholders are beginning to doubt Argentina's B grade from S&P Global Rating. According to JP Morgan, Argentine creditors lost 23% this year, while sovereign note holders of Ecuador, presently rated B-, is around 9.4%. Politics has a lot to do with it, Ecuador's government is in an attempt to shore up public finances and there is the possibility of officials sitting down with the IMF in 2019, while Argentina's current president is in preparation of re-election with inflation expected to be 20% and an economy in recession. Argentina's economy is particularly vulnerable due to a disputes between former and present presidents. (Bloomberg)

More Turkish firms applied for bankruptcy protection

Dec 27. The number of Turkish limited and joint stock companies who have applied for protection from creditors increased to 979 since a currency crisis peaked in August 2018. They are asking the courts to give them stays of execution due to the economic turmoil that pushed up borrowing and imports cost. A political crisis with the United States earlier in 2018 had negatively affected Turkish enterprises, as would US sanctions on Iran. Still, exports are expected to contribute to the Turkish's economic growth, although the pace of economic activity in Europe is expected to slow. (Ahval News)

Bank of Japan divided over side effects of easy policy

Dec 27. Bank of Japan (BOJ) policymakers grew divided as they failed to reach an agreement on the feasibility of allowing bond yields to move more flexibly around the central bank's zero per cent target. With inflation far from its 2% target, policymakers may be forced to maintain a massive stimulus programme, causing negative spillovers on the financial sector as financial institutions' profits got hit by the near-zero interest rates. One member who supported a more flexible bond yields movement stated that maintaining the long-term rate target at around 0% could diminish the effect of monetary easing. Another member disagreed, stating that giving way to a more flexible long-term yields could be viewed as though the bank's commitment to achieving 2% inflation was compromised. However, the nine-member board agreed on the need to maintain monetary policy ultra-loose for the time being, while staying cautious to the impact of prolonged stimulus on Japan's banking system. (Business Times)

Collapse of ethical lenders stokes fears over access to credit

Dec 26. Ethical lenders that have been touted as alternatives to high-cost firms are going out of business at the fastest rate in years due to rising regulatory and technology costs, fuelling concerns that less well-off customers are vulnerable to losing credit access. This year, eight credit unions across the UK have collapsed, affecting 14,000 customers with more than GBP 25mn savings. Critics say the sector is held back by a lack of professionalism and inability to keep up with the demands of running a modern financial provider such as offering more digital services. Credit unions are also subject to stricter rules on how they can raise cash, as compared to mainstream banks. (FT)

New year, old problems for Italy's banking sector (FT)

Debt waiver to slow down state capital expenditure (Economic Times)

Greece eyes bond issues up to EUR 7bn in 2019 (Ekathimerini)

Regulatory Updates

Bankruptcy bill aims to keep more small businesses open

Dec 27. Small businesses with less than USD 2.5mn in debt would be able to file bankruptcy more quickly and cheaply under the proposed new bill, where firms will be treated more like individuals rather than corporate filers. Furthermore, small business owners would also find it easier to maintain their ownership interests due to the presence of a standing trustee overseeing every case, which will also benefit creditors. Under the bill, small business owners could retain a stake in the firm as long as the reorganization plan does not discriminate unfairly. The bill will also speed up the reorganization process as it forces small business to file a plan within 90 days instead of the 120 days in Chapter 11. (Bloomberg Law)

Indian government mulls easing related-party rule

Dec 27. The Indian government is considering relaxing the “related party” criterion under the Insolvency and Bankruptcy Code (IBC) to make it less restrictive and give conditional approval to certain relatives of defaulting promoters to bid for stressed assets. Currently, related parties including relatives of individuals who have run a stressed company are barred from bidding. Some analysts have said the scope of the current definition is too broad to disqualify many people unless more clarity is brought in. (Financial Express)

Bank-led resolution of NPAs set to begin (Economic Times)

Government set to fund six state-run banks under PCA framework (Bloomberg Quint)

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