Junk oil companies’ yields unexpectedly fell

by Jiang Zhengyi

The oil and gas sector in the US has been hit by a wave of credit rating downgrades after the plunge in oil prices. This weighed on the performance of corporate bonds, and default rates are expected to rise. During January S&P downgraded eight high-yield oil and gas companies including Energy XXI, putting them deeper into junk territory (see Table 1). The set of ratings downgrades has been the largest for a single sector since 2009. However, it seems that the rating revisions are not yet over. There are five oil and gas companies, including ION Geophysical and Magnum Hunter Resources, on the list of “weakest links” by S&P. With a rising risk of default, they could be downgraded in the coming months.

Company Name	Company Type	Credit Rating	
		From	To
WPX Energy Inc	Listed	BB+	BB
Energy XXI Ltd	Listed	B+	B
Warren Resources Inc	Listed	B	B-
Swift Energy Co	Listed	B	B-
Midstates Petroleum Co Inc	Listed	B	B-
Magnum Hunter Resources Corp	Listed	B-	CCC+
Black Elk Energy Offshore Operations LLC	Private	CCC+	CCC-
Rooster Energy Ltd	Private	CCC+	CCC-

Table 1: The downgrades eight US oil and gas exploration and production companies. *Source: Standard & Poor’s*

The downgrades are reflected in the increasing RMI aggregate 1-year Probability of Default (RMI aggregate 1-year PD) from July 2014 to Jan 2015. There were six listed oil companies among the eight that were downgraded by S&P. The right hand side of Figure 1 shows that their aggregate PD, defined as the median of the individual PDs, grew at an accelerating pace up to Jan 2015. The change of aggregate PD is accompanied by a reversed trend in global oil prices, which started to decline from June 2014 and reached its bottom also in Jan 2015. Oil prices have dropped by around 50% over the past half year, corresponding with a surge in aggregate PD during the same period with the RMI aggregate 1-year PD peaking at 1044bps at the end of Jan 2015.

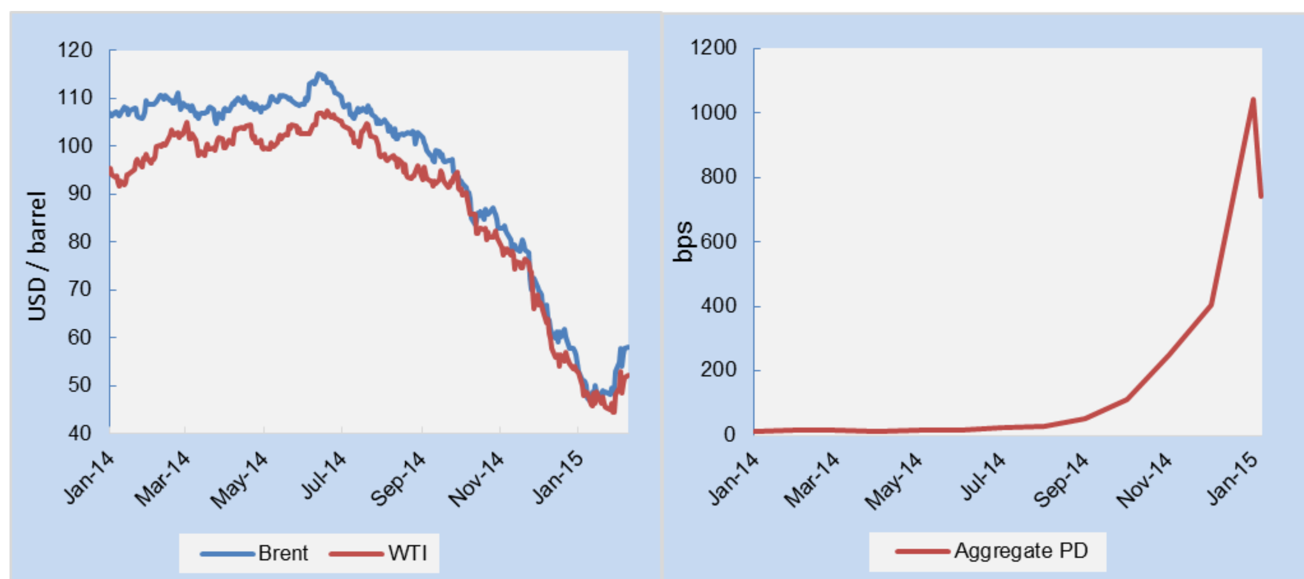

Figure 1: Brent and West Texas Generic 1st month crude oil future prices and RMI aggregate 1-year PD of the six listed oil companies among the eight that were downgraded by S&P. *Source: Bloomberg and Risk Management Institute.*

However, in recent years, the US high-yield bond market had seen an influx of bonds issued by capital expenditure intensive energy companies, which could be affected by the falling oil price. Despite this, S&P suggested that most lower-rated companies were found to have enough liquidity for the coming year, due to their refinancing of revolving credit facility drawings ahead of the price drop and cutting back on capital expenditure plans to preserve liquidity. What's more, worrying that energy companies may default as oil prices plummet, the US investors have poured nearly USD 2.7bn into mutual funds and exchange traded funds invested in junk debts in the week ended on February 4. Table 2 shows that as a result of investors' zeal for junk debt, the bond yields of the downgraded oil companies have been pushed down in the recent month.

Company Name	Maturity	Issue	Currency	Bond Yields (%)				
				2015/1/5	2015/1/12	2015/1/22	2015/1/30	2015/2/6
WPX Energy Inc	Jan 15, 2017	Sep 8, 2014	USD	6.72	6.87	6.80	6.51	5.82
Energy XXI Ltd	Dec 15, 2018	Nov 22, 2013	USD	44.37	43.90	43.26	39.55	34.53
Warren Resources Inc	Aug 1, 2022	Aug 11, 2014	USD	18.45	19.09	19.96	20.96	19.24
Swift Energy Co	Jun 1, 2017	Jun 1, 2007	USD	23.77	24.46	35.66	29.01	24.45
Magnum Hunter Resources Corp	May 15, 2020	Nov 7, 2013	USD	16.18	16.05	18.98	17.12	14.48

Table 2: Bonds and the yields of the five listed companies. Data for Midstates Petroleum Co Inc is unavailable. *Source: Bloomberg*

Recently, crude oil has rebounded 24% from a six-year low level that the market had reached in January 2015. Brent crude, for example, rose by USD 3.16 to USD 57.91 per barrel in London on Feb 3, the biggest four-day price advance since 2009. Contracted drilling activities in the US and oil companies' actions on cutting spending may have contributed to the recovering oil price and thus improving credit profiles, as reflected by the rebounded oil prices on the left hand side and dropping aggregate PD on the right hand side of Figure 1. Nonetheless, some analysts believed that the oil price pick-up was nothing but a temporary rebound and there was still room to fall.

Source: Default risk rises in US oil and gas sector (FT)
S&P downgrades eight US oil and gas firms (Reuters)
Investor zeal for junk debt heats up (FT)

Credit News

Singapore isn't Greece, Temasek tells S&P in 29 pages

Feb 06. Singapore's Temasek Holdings has told Standard & Poor's in 29 pages why it shouldn't change the state-owned investor's AAA rating. According to a response for the new rules for grading investment holding companies on Feb 2, S&P lumped riskier nations such as Greece and Jamaica with Singapore, which has had an AAA rating for 20 years. The new criteria also consider the firms' lack of direct ownership of assets, the challenges they face when selling in illiquid markets, and the volatility of assets they hold. (The Straits Times)

RadioShack files for Chapter 11 bankruptcy

Feb 05. Electronics retailer RadioShack Corp filed for US bankruptcy protection on Thursday. However, it could be suffering less than other Chapter 11 retailers by making a deal with an affiliate of hedge fund, Standard General, which is one of the lenders and the largest shareholder of RadioShack. Standard General brought 2,400 stores of RadioShack and reached an agreement with wireless company, Sprint Corp, which could occupy about one-third of each RadioShack store. (Reuters)

S&P cuts European banks on rules forcing losses on bondholders

Feb 04. Six European banks, including Credit Suisse Group AG and HSBC Holdings Plc, had their ratings cut by Standard & Poor's on the prospect that their governments are less likely to provide aid in a crisis. The EU enacted the bank-resolution law last year in a bid to end taxpayer bailouts that prevailed in the financial crisis. Under the new rules, authorities will, as a general rule, require 8% of a struggling bank's liabilities to be wiped out before recourse can be made to industry funds or taxpayer support. (Bloomberg)

European Central Bank resists latest Greek bailout plan

Feb 04. Yanis Varoufakis, Greek finance minister, had proposed to European officials that Greece raise EUR 10bn as "bridge financing" by issuing short-term treasury bills to tide the country over for the next three months while a new bailout is agreed with its Eurozone partners. However, the European Central Bank is unwilling to approve the debt sale, which could make Athens exiting its bailout by the end of the month, with no source of outside funding. (FT)

Debt mountains spark fears of another crisis (FT)

China's disinflation risk signals more room for monetary easing (Bloomberg)

European companies dig deeper to fill pension holes (FT)

Probe into Moody's deepens after S&P agrees USD 1.4bn settlement (FT)

Regulatory Updates

Malaysia unveils bank funding rules amid squeeze on liquidity

Feb 09. Malaysia's central bank has unveiled new rules governing the way local banks should account for certain deposits and other items on their balance sheets, in a move that may ease the recent squeeze in the ringgit money market. Specifically, deposits which are subject to an early-withdrawal penalty of at least 50% of accrued interest can be treated as "qualifying term funding," or money that can be lent out, with effect from June 1. Unrestricted investment accounts will be subject to a 10% run-off rate from the same date. (Strait Times)

US scrutiny of Barclays and UBS widens forex trading probe

Feb 08. The US Department of Justice is examining currency-linked investments offered by Barclays and UBS. Currently The agency is looking into whether the two banks sold so-called structured products without disclosing the profit they were making from currency trades used to generate the products' returns. In addition, the Department of Justice is also investigating other banks over allegations of inadequate profit disclosure to clients and counterparties involved in currency deals. (Reuters)

India central bank announces framework for banks' countercyclical capital buffer

Feb 05. Indian banks will have to set aside up to 2.5% of risk weighted assets to satisfy the countercyclical capital buffer requirement set by the Reserve Bank of India. The amount of capital buffer will depend on macroeconomic indicators such as the credit to GDP ratio and gross non-performing bad loans. The countercyclical capital buffer is part of the Basel III capital framework and is implemented by member jurisdictions worldwide. The buffer has been designed to increase the resilience of the banking sector in periods of excess credit growth. According to the Basel III guidelines, banks have to implement the countercyclical capital buffer over a period of three years between 2016 and 2018. (Business Times)

Regulations hit smaller US banks hardest (FT)

FSB rules threaten to reshape structured note industry (SCMP)

BoE urges "big push" on bank rules, worries over reform fatigue (Reuters)

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