Russian companies' credit risk spikes as the initial fallout of the Russia-Ukraine war takes effect

by NUS-CRI Market Monitoring Team

- **The NUS-CRI Agg PD shows the credit risk of Russian companies immediately spikes as Russia attacks Ukraine**
- **Economic sanctions hinder short-term financing and operational capabilities of Russian companies, meanwhile the Bank of Russia aims to mitigate inflationary pressures and a tumbling Ruble by increasing interest rates**
- **Disproportionate impact on credit risk for different industries demonstrates that financial health of those industries that tend to be susceptible to state control are especially vulnerable to investor sentiment and economic sanctions**

At the start of the month, NUS-CRI published an issue detailing the rising credit risk of Russia-domiciled corporates (Russian Companies) on the back of rising geopolitical tensions between Russia and Ukraine. On February 24th, 2022, Russia launched a 'full-scale' attack on Ukraine that has raised geopolitical tensions in Europe to levels not seen since the second world war. Notwithstanding the expected impact of a war with Russia, and the resultant impact on the operational viability of Ukraine-domiciled companies adversely impacting their credit risk (See Figure 1), the initial fallout of the Russian invasion of Ukraine has rattled global markets and further threatened the financial health of Russian companies. This is showcased by the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) catapulting to multi-year highs. The imposition of sanctions by western economic giants such as the United States, United Kingdom, and other core European Union member countries drive up credit risk in the short term, adversely impacting supply chains for major commodities exported from Russia and the depreciation of the Ruble.

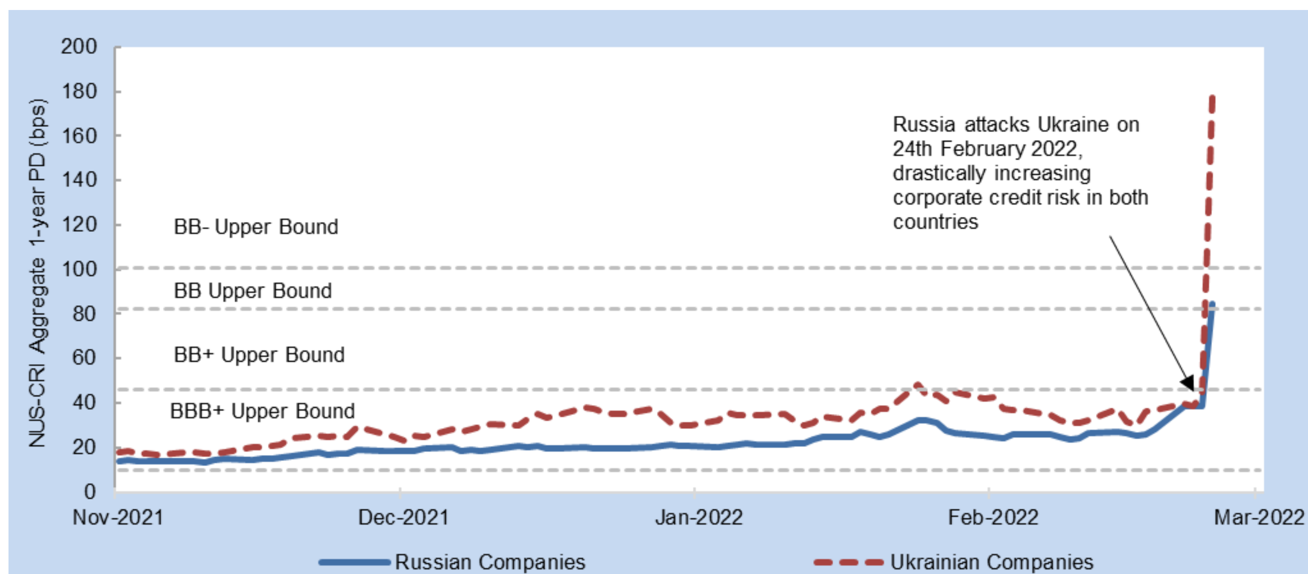

Figure 1: NUS-CRI Aggregate (median) 1-year PD for Russian and Ukrainian companies from Nov-2021 to Feb-2022 with reference to PDiR2.0 bounds[1]. *Source: NUS-CRI*

The response of global markets to Russia's attack on Ukraine has raised concerns regarding Russian companies' operational and financing capabilities under the current extremely adverse macroeconomic environment. Russian companies have already had to grapple with high levels of inflation prior to the war, which had led to a hike in policy rates to 9.5%. Now, as Russia's invasion and accompanying sanctions from western

[1] 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.

economies drive domestic and international operational uncertainty for Russian companies, interest rates have been more than doubled by the Bank of Russia (BOR) to 20% in order to mitigate skyrocketing inflation and to provide a cushion to the rapidly depreciating Ruble. A depreciating Ruble not only adds to the inflationary pressures in Russia but also impacts Russian companies' ability to service their foreign debt obligations. The yield on corporate bonds continues to climb higher as newer sanctions, aimed at cutting off Russia's economy from the international markets, are introduced. For example, one of Russia's largest companies, Gazprom PJSC, saw the price of its USD-denominated bond maturing in March-2022 fall by 40%, catapulting yields to extreme highs. A Similar increase in yields can be seen throughout a basket of Russian corporate bonds as economic uncertainty regarding the impact of the war in the short-term for Russian corporates raises fear for investors around the globe (See Figure 2a). The sell-off witnessed in Gazprom's bond also demonstrates that Russian companies, even those that may have been heralded as investment-grade prior to the war (See Figure 2b), will likely be facing refinancing troubles in the short term due to the sanctions and the resultant contagion effect in the market.

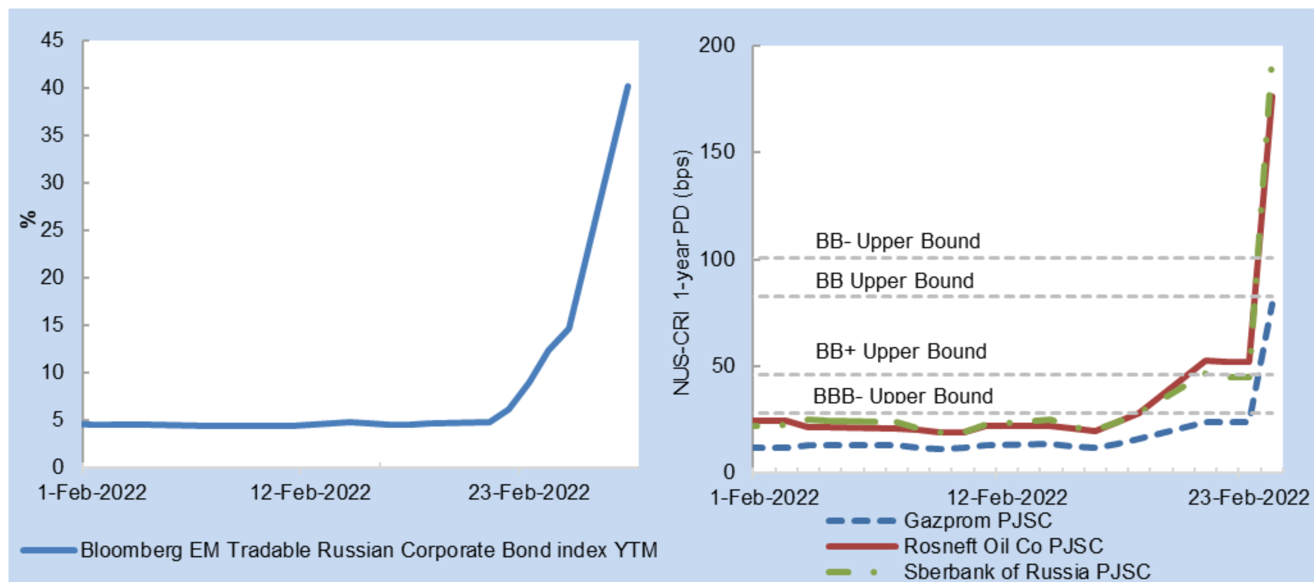

Figure 2a (LHS): Bloomberg EM Tradable Russian Corporate Bond index YTM in Feb-2022. Figure 2b (RHS): NUS-CRI 1-year PD for Gazprom PJSC, Rosneft Oil Co PJSC, and Sberbank of Russia PJSC in Feb-2022 with reference to PDiR2.0 bounds. *Source: Bloomberg, NUS-CRI*

Furthermore, sanctions on Russia that are isolating Russian banks from the international SWIFT platform are expected to adversely impact the overall banking capabilities of Russian corporates, including lending operations by Russian banks, as their ability to trade and deal with foreign counterparties is hampered. This will likely negatively impact Russian companies' liquidity and profitability, especially those in industries that are heavily involved in exporting activities, as sanctions hinder settlements of foreign transactions. Additionally, the inability to tap into their USD 630bn foreign reserves has forced the hand of the Russian central bank to implement alternative methods to further cushion their economy. In order to support the rapidly depreciating Ruble, the BOR required companies, such as Gazprom and Rosneft, to convert 80% of their foreign-currency-denominated revenues into Ruble. Should further sanctions continue to hinder the central bank's ability to tap into their reserves and cushion the tumbling Ruble, similar actions may be forced onto companies, especially those that are state-owned, increasing their vulnerability to the effects of sanctions and the ongoing war by reducing their non-Ruble denominated buffer.

Additionally, sanctions pertaining to export controls implemented by the US aim to block Russia's import of semiconductors and other software-related technologies which are essential components for Russia's technology sector[2]. This will severely hinder Russian manufacturing, technology, and defense industries as production lines will be halted, impacting their operating revenues and profitability in the medium term. The US is also planning to limit Russia's ability to do business in dollars and other major currencies including euros, pounds, and yen. Given that one of Russia's primary export partners is the European Union, Russian companies' inability to access those markets may lead to the loss of key sources of revenue generation. More subtly, the economic conflict also brings profound risks for Russian companies in the longer term as businesses in Russia may face a harsher operating environment, especially when dealing with foreign stakeholders. Additional prohibitions have also been added on new debt and equity offerings of major Russian state-owned companies

[2] Though they will have an impact on the technology sector, the aim of these sanctions is to stagnate the sustained growth in Russia's military capabilities, where these technologies are essential.

and large financial institutions, restricting their ability to raise capital. This, as well as the BOR's restricted ability to offer foreign-currency liquidity to Russian companies and banks, is likely to contribute to an increase in Russian companies' credit risk for their foreign currency obligations.

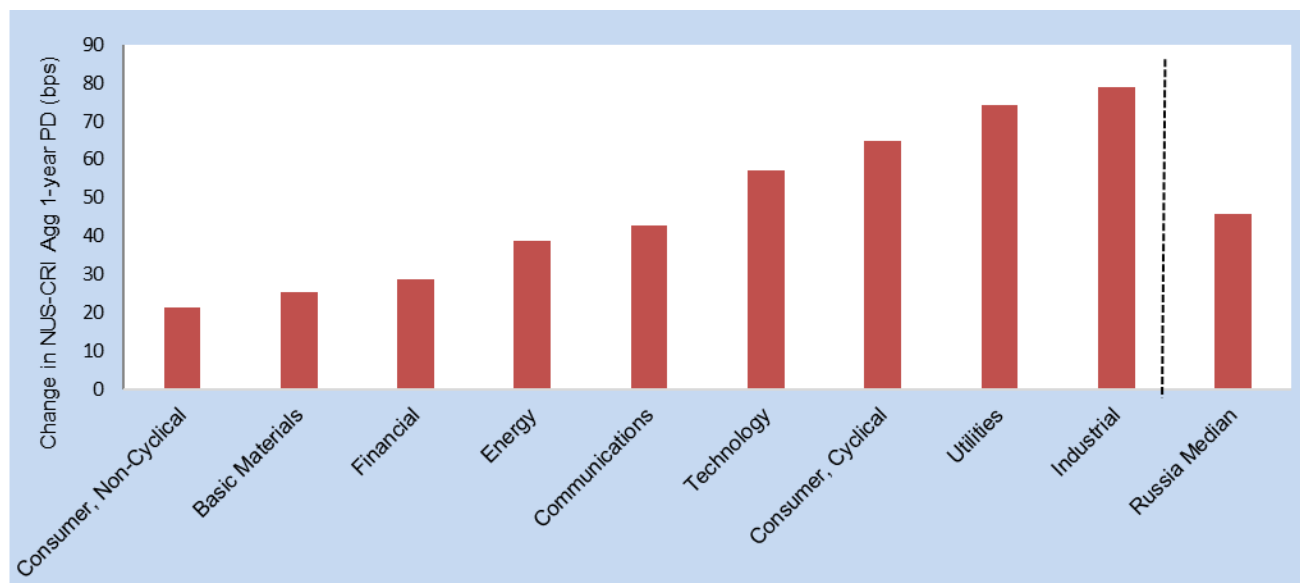

Figure 3: One day change in NUS-CRI Aggregate PD (median) by sector as per BICS 2007 classification for Russian companies on Feb 24, 2022. *Source: NUS-CRI*

As seen from Figure 3 above, the impact of the war on Russian corporates' credit risk, though adverse for all sectors, has been disproportional. The utilities and industrial sectors were among the worst hit with the highest 1-day change in Agg PD on Feb 24. Unsurprisingly, state-owned enterprises may make up a significant proportion of these sectors and thus are more susceptible to sanctions and sell-offs by global investors. Russian industrial metal exports have witnessed a decline in demand since Russia initiated the attack on Ukraine. The declining demand is expected to persist as buyers remain averse to source Russian metals. As such, both the industrials and utilities industries are more likely to continue experiencing elevated credit risks should the current macroeconomic conditions persist[3].

On the other hand, the energy sector has largely been spared from sanctions and remains relatively unscathed due to its critical role as Europe's key energy supplier. Russia provides around 40% of Europe's natural gas, which is a critical input for Europe's power plants and other industrial processes. As a result, Europe's need to protect its energy supply and prevent a surge in oil prices, in order to minimize disruptions to its supply chains, likely means that western governments will remain reluctant to impose further sanctions on Russia's energy sector, as demonstrated by the exemption of Russian energy transactions from financial sanctions. However, the effects of broader sanctions on banks may spill over into the energy sector[4]. The adverse impact of sanctions on operations has led major foreign players to exit the country. For example, Shell has announced its exit from a joint venture with Russian state-owned gas-exporter Gazprom, while BP has announced its plans to exit its stake in another state-owned company Rosneft. The exit of these major foreign gas companies from their Russian counterparts is likely to lead to a deterioration in Russian gas companies' liquidity position after divesting.

Although talks between Ukrainian and Russian delegations have been initiated, fighting still rages on and a continuous barrage of economic sanctions continues to cloud Russia's economic outlook in the short term. Although the Russian economy may find some relief in strong commodity prices[5], it is likely that Russia will witness an increase in foreign-domiciled firms cutting business ties with domestic corporations. With major foreign firms such as BP and HSBC exiting the country, Russian companies and the broader economy are becoming increasingly isolated from the rest of the world. Resultantly, given that Russia is a heavily export-driven economy, the disclination of corporates to do business with Russia on a moral ground does not bode well for future operations. Furthermore, continued stringent sanctions may also ensure that higher commodity prices

[3] Foreign banks like Societe Generale SA, Credit Suisse AG and a few state-owned Chinese banks have restricted funding for purchase of Russian commodities which adds further pressure on the sector.
[4] Exclusion from the SWIFT payment system, may also exacerbate difficulties faced by Russian energy companies, as buyers may prefer alternate non-Russian sources of oil, which would further reduce the price realization of Russian companies.
[5] Commodities account for around 70% of Russia's goods exports, and should crude prices remain around USD 90, Russia could expect a USD 65bn boost in its budget.

no longer serve to mitigate against their economic impact going forward, especially as Russia's access to the SWIFT payment system remains blocked. As such, continued hindrance to trade and capital access will potentially result in further deterioration in the credit health of Russian companies as the region deals with the incumbent macro-political crisis.

Credit News

Junk Russia bonds mirror ruble drop as sanctions bite

Feb 28. Russia's bonds extended declines driven by announcement of additional sanctions on the country's central bank and a credit downgrade to junk status. Investors resultant flight to safety caused the yields on the country's dollar denominated debt to double in this month. Harsh sanctions and capital controls have dealt a severe blow to Russian assets, wiping billions off their value. In a move to mitigate the fallout of the sanctions and depreciating ruble, the central bank doubled its key rate to 20% on 28th Feb and banned residents from transferring currency abroad. (Bloomberg)

Europe freezes Sberbank units as sanctions squeeze liquidity

Feb 28. After Russia invaded Ukraine, Europe froze the main operations of Sberbank PJSC in the EU. Sberbank Europe and its subsidiaries have experienced significant deposit outflows amidst geopolitical tensions, leading to a deterioration in its liquidity position. Meanwhile, the US imposed sanctions on five of Russia's largest banks, including Sberbank, preventing these national banks from accessing the international SWIFT transaction messaging system. As such, European Central Bank determined that Sberbank Europe AG and its subsidiaries may not be able to repay debts or other liabilities that come due, suspending most payments across Sberbank's three divisions until March 1. (Bloomberg)

Credit cycle turning as Ukraine war adds to inflation concerns

Feb 26. Leveraged loans have proven more resilient than corporate bonds, amidst inflation concerns and the impending Fed rate hike in Mar-2022. Thus far, investors remain sanguine about lending to risky companies, as default rates are expected to remain low and corporate earnings remain solid. Sell-offs in credit markets have been more about the expected path of interest rates than rising credit risk. Yet, with the Russia-Ukraine crisis, the oil price surge and supply chain disruptions could add pressure to rising prices. Slowing growth could propel a sell-off from being mostly contained to interest rates to threatening corporate credit. The average price of US leveraged loans in a widely watched index slipped to its lowest level since Aug-2022 this week, while US high-yield credit spreads have crept higher, indicating slow-rising credit risk. There is growing unease among some investors over the conflict and whether it is enough to turn concern over rising prices into worries over corporate credit. (FT)

Investors brace for flood of mortgage bonds when Fed trims balance sheet

Feb 27. Investors expect turbulence in the mortgage loan market as the Federal Reserve attempts to achieve a planned reduction of its USD 9 tn balance sheet. Although the Fed has committed to reduce its holdings of treasuries and mortgage-backed securities in a expected and planned manner, the timing and speed of reduction is yet unknown. Communication from the Fed suggests that the reduction may be through sale of mortgage-backed securities, which is an aggressive approach as opposed to allowing the securities to mature. An oversupply of mortgage bonds in the market could lead to lower prices and yields. (FT)

Corporate fundraising slows sharply as war in Ukraine shakes markets

Feb 26. Longer-lasting inflation raised market fears as oil prices climbed higher. The threat of rising interest rates led to a sharp sell-off in high-growth stocks, which has been exacerbated by Eastern European tensions. Therefore, global corporate bond issuance has dropped and the equity funding pace has slowed as market participants await an easing in the turmoil triggered by Russia's invasion of Ukraine. For example, companies around the world raised about USD 60bn in bonds last week, much lower than more than USD 125bn the week before and the year-to-date average of nearly USD 100bn. This is because many companies planning to issue bonds have decided to delay issuance due to market conditions. The decline was especially noticeable for lower-rated high-yield bonds, as the US high-yield bond market reached the worst start on record for data going back to 2000, with 4.2% losses so far this year. Meanwhile, the developments in Ukraine are expected to further dampen the IPO market. (FT)

China's stimulus fails to jolt construction in blow to economy (Bloomberg)

Logan bonds set for their worst week as debt worries resurface (Bloomberg)

China state banks restrict financing for Russian commodities (Bloomberg)

Regulatory Updates

US bans transactions with Russian central bank

Feb 28. The US has announced a slew of severe sanctions aimed at dealing severe damage to Russian economy and financial system. The US has initiated a ban on transactions with Russia's central bank, imposed a fresh batch of sanctions on the country's sovereign wealth fund, Russian Direct Investment Fund and its chief executive, Kirill Dmitriev. The steps come in light of a joint commitment by western nations to deny Russia access to foreign reserves of around USD 630 bn and effectively preventing Russia's use of foreign reserves to circumvent sanctions. (FT)

Russia erects financial defenses to shield economy from curbs

Feb 28. The Bank of Russia has raised its key interest rate to 20%, and imposed controls on the flow of capital, to shield the economy from sanctions that have hit the financial sector particularly hard and blocked access to the central bank's USD 640bn buffer. Facing risks of a bank run, a rapid sell-off in assets and a depreciating ruble, policymakers have also banned brokers from selling securities held by foreigners while exporters were ordered to start mandatory hard-currency revenue sales and stock trading was temporarily suspended. The ruble will also not be allowed to breach a certain range unless the central bank shifts the trading corridor. While the oil and gas sector has largely escaped sanctions and could provide some relief, wild swings in the exchange rate and the soaring cost of money could still cause severe damage to the economy. (Bloomberg)

Europe seeks to hand crypto oversight to new dirty-money watchdog (Bloomberg)

UK companies feel post-Brexit rules pain (FT)

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