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# Uncertain operating environment poses headwinds to the credit outlook of Indonesian coal miners

by NUS-CRI Market Monitoring Team

- **NUS-CRI Forward PD indicates that the credit risk outlook of Indonesian coal miners may deteriorate due to operational headwinds should China reverse its ban on Australian coal and as the country pushes towards greener alternatives**
- **Stress tests conducted using the BuDA toolkit suggest that vulnerable miners are more susceptible to a slowdown in export volume to China**

Growth in the coal market is set to accelerate as demand from China, one of the key importers of the commodity, rebounds due to its reopening. Coking coal is a vital fuel source used in blast furnaces for steelmaking, and with construction activity in the country poised to pick up steam, coal miners from countries with significant export exposure to China are poised to benefit, the largest of them being Indonesia. As seen from Figure 1a, the NUS-CRI aggregate (median) 1-year Probability of Default (Agg PD) for Indonesian coal miners is relatively stable around the BBB+ upper bound proxied by PDiR2.0. However, the NUS-CRI aggregate (median) Forward 1-year Probability of Default (Forward PD[1]) suggests that the industry is likely to face headwinds over the next twelve months, potentially due to a loss of earnings as the China-Australia coal-trade relationship improves and as Indonesia continues its push towards producing greener alternatives.

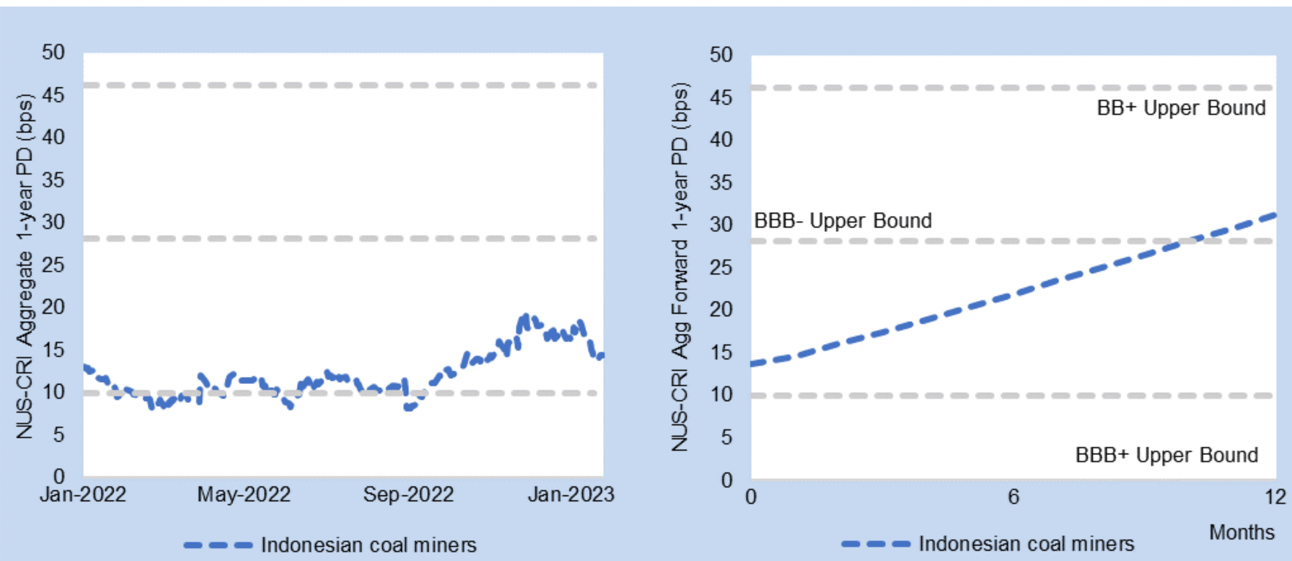


Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Indonesian coal miners with reference to PDiR2.0[2] bounds. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Indonesian coal miners as of Jan-2023, with reference to PDiR2.0 bounds. *Source: NUS-CRI*

Since last year, coal markets globally have been rallying due to Russia's invasion of Ukraine, which has brought energy security concerns to the forefront of major western governments' policies.[3] To capitalize on the rising global and domestic energy needs, Indonesia's coal miners have ramped up production and exports of coal throughout last year, producing 687mn tonnes of coal (up from a target of 663mn tonnes) and exporting close to 70% of it. This increase in revenue gained from higher production and exports (see Figure 2a) has improved

[1] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly 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 – this is conditional on the firm's survival in the next 6 months.
[2] 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.
[3] This has been extremely profitable for the global coal mining industry, where the top 20 largest coal miners in the world saw their earnings reach USD 97.7bn, up 246% YoY.

the credit profile of Indonesian coal miners as their median Total debt to EBITDA fell from 1.21 to 0.21 between Q3 2021 and Q3 2022. Simultaneously, the industry's median liquidity and debt servicing ability also improved, with the current ratio increasing from 1.67 to 1.99 and the interest coverage ratio increasing from 24.85 to 28.75. A holistic improvement in the industry's credit profile, primarily due to the increase in coal prices that catalyzed the growth in earnings, has given the industry additional buffer to deal with the wider structural challenges and capital expenditure required to meet the country's goal to transition away from fossil fuels.

However, headwinds do remain, as suggested by the Forward PD in figure 1b. Global demand for coal may face downward pressure in the short run as cooling temperatures and government-led efforts to curb inflation take effect. The price of coal, measured using the generic 1st coal, Newcastle monthly contract, tumbled down to as low as USD 262/MT near the end of this month, after reaching an all-time high of USD 458/MT in Sep-2022. Adding another woe to the Indonesian coal miner's earnings is the potential resurrection of a trade agreement between Australia and China. In 2020, Beijing imposed an unofficial ban on coal trade with Australia. However, as of Jan-2023, three Chinese state-owned utilities got approval from the Chinese central government to import Australian coal. This puts Indonesian coal miners' export revenue at risk, given that Indonesia became one of the leading coal exporters to the country, and aids China to meet the domestic supply gap left by Australian miners.

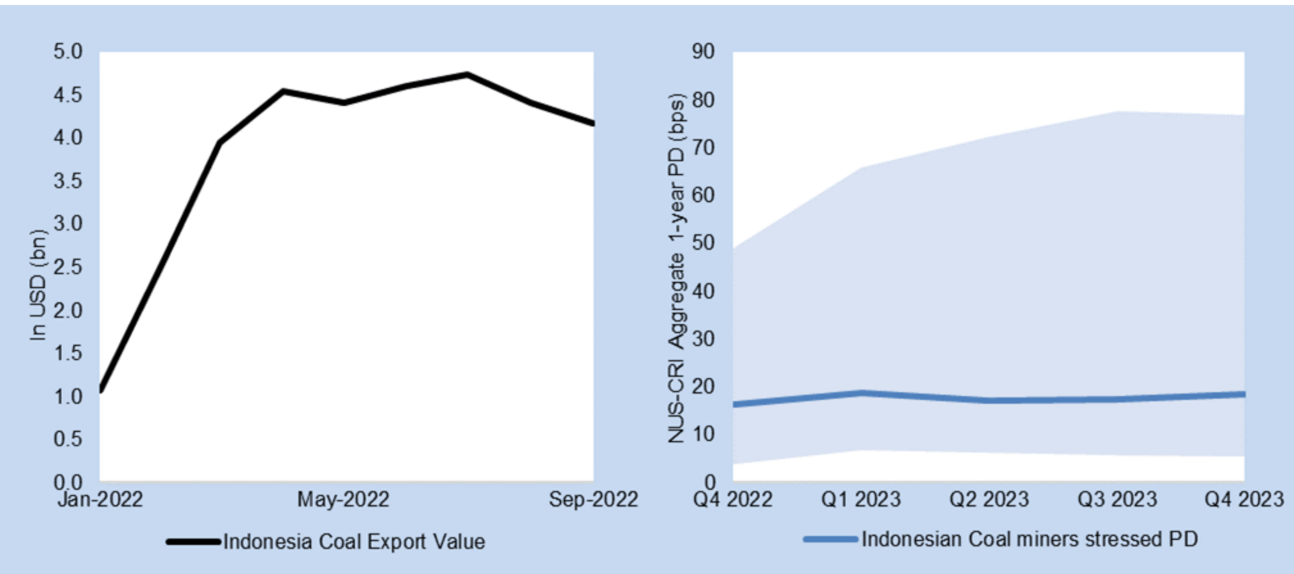


Figure 2a (LHS): Total value of exports (in USD bn) of Indonesian coal. Figure 2b (RHS): NUS-CRI Agg (median) 1-year PD for Indonesian coal miners based on stress tests conducted using price, Chinese import volume of Australian and Indonesian coal. *Source: Bloomberg, BuDA v3.5.1*

To gauge the impact of how Indonesian miners' credit risk might respond to an increase in China's Australian coal imports, stress tests can be conducted using the NUS-CRI Bottom-Up Default Analysis toolkit (BuDA Toolkit[4]) by stressing the PD of Indonesian coal miners against coal price and Chinese import volume of Australian and Indonesian coal[5]. Figure 2b shows the interquartile range of stressed PD that suggests that the brunt of the impact will be felt by vulnerable companies (those above the 75th percentile), possibly due to them being less robust to absorb the loss in earnings and market share stemming from a resurgence of Australian coal imports to China.

Furthermore, Indonesian coal miners also face heightened financing challenges as the country faces global pressure to transition away from fossil fuels. In the recent G20 summit, Indonesia signed a USD 20bn deal agreeing to accelerate the shutdown of coal-fired plants and increase the proportion of renewable energy in its domestic energy mix. As the push towards clean energy intensifies, it further constricts the financing options available to the country's coal miners. Banks, which have been a major source of financing for the industry, are now facing increasing public pressure to curb lending to the sector. The Indonesian Financial Services Authority has directed bigger lenders to transition away from coal sector financing. With the overall push to transition to cleaner sources, financing may be redirected to renewable energy projects as the country shifts its energy production capabilities towards greener alternatives.

[4] The Bottom-up Default Analysis (BuDA v3.5.1) is a credit stress testing and scenario analysis toolkit jointly developed by the Credit Research Initiative (CRI) team of National University of Singapore (NUS) and the International Monetary Fund (IMF).
[5] In this scenario, we assume that the price of coal is going to increase by 5% MoM due to rising demand originating from China, Australian export volume to pick up steam by 5% MoM, and Indonesian export volume to decrease by 10% MoM.

Though 2022 has been a strong year for Indonesian coal miners due to strong export volumes and a holistic improvement in their credit profile, the industry is facing a tougher operating environment over the coming quarters. In particular, should China and Australia restore their trade relationship, it is possible that Indonesian coal miners may need to increase exports to alternative countries to maintain their competitive position as market leaders in global coal exports. Nevertheless, China's demand for coal also depends highly on the pace of economic recovery in its construction industry, as a slow pick-up in energy demand might hamper the amount they import. As the stress tests conducted using the BuDA toolkit might suggest, vulnerable companies in particular will be hard hit by such a slowdown.

## Credit News

### Libor is still due to die, but companies may use extensions

**Jan 26.** Though the June phaseout deadline of Libor is coming, there are still companies that haven't switched to the U.S. regulators' preferred new benchmark rate, SOFR. For now, U.S. leveraged-loan deals of USD 1.09tn are still underpinned by Libor, among which about 9% have no successor, and around 56% have room for transition via amendments with the lender's permission. The rest 35% will directly shift to SOFR at the deadline. Companies may still have hesitation regarding the cost of rate transition and may choose to lock in the Libor loan contract for another term, however, this Libor-locked contract will not be allowed to revolve or increase in size without converting to SOFR. (WSJ)

### World's ESG debt pile to shoot past USD 5tn as sales pick up

**Jan 27**. As the pursuit of sustainable investments gathers steam, the total value of sustainable debt has surged close to USD 5tn. The Institute of International Finance (IIF) estimates that 2023 will see a USD 1.7tn increase in sustainable debt sales and an increase of USD 2tn in 2024 driven by governments' adoption of sustainable frameworks and efforts by commercial banks to de-carbonize loan portfolios. (Bloomberg)

### Wall street rides loan-market rally to sell risky buyout debt

**Jan 25.** Global banks are taking advantage of the loan-market rally to sell parts of risky loans that they have been saddled with. However, despite the current progress, wall street banks still have a considerable amount of risky debt on their balance sheets which may take some time to offload. Investors believe that the current rally may continue if it is supported by global growth, allowing them to continue offloading more debt. As market expectations of a soft landing by the Fed continue to increase, risky debt has witnessed renewed investor interest. There was a USD 3.2bn jump in the issuance of new CLOs, an instrument considered to be a key demand driver of risky debt. (Bloomberg)

### China property bonds rebound on support measures from Beijing

**Jan 24.** Buoyed by the support measures of the Chinese government, China's indebted real estate developers have shown massive improvement over the past 2 months. The HY dollar bond index of China which is mostly made up of property developers has surged by close to 50% since Nov-2022. As authorities soften their stance, property developers have found it easier to raise new debt, with the international debt markets also showing signs of revival. (FT)

### EU debt suffers under competition with sovereign borrowers

**Jan 25.** The EU's borrowing costs have increased more rapidly than many of the bloc's governments since last year. Though the credit rating of the EU is better than that of France, the ten-year EU bonds are traded at a yield of 2.63%, 9 bps higher than France's. For some shorter maturities, the EU's yields are even higher than those issued by some riskier sovereign issuers namely Spain and Portugal. Though the investors don't take the yield difference as a reflection of real credit quality given the fact that the EU bonds are usually over-subscribed, it does help encourage the bloc's member states to issue more in the debt market. (FT)

**Kepco debt crisis exposes South Korean vulnerabilities** (FT)

**China's EXIM bank gives Sri Lanka debt extension** (Reuters)

**Ghana reaches deal with insurers on domestic debt exchange** (Bloomberg)

## Regulatory Updates

### Central banks set to lift interest rates to 15-year highs as investor jitters grow

**Jan 30.** The world's leading central banks are about to raise interest rates to the highest level since the financial crisis. The bond prices have been rising and the corporate bond funds are seeing money inflows as the markets expect slower interest hikes or even rate cuts since the start of 2023, which seems to be dubious given what the Fed is likely to bring about - a recession. The investor expectations going against the economic data and the tightening monetary policies may result in further bond market turmoil if the central banks keep rates high or raise them by more than investors bet. (FT)

**BOJ deploys funds-supply tool again as yields creep up**

**Jan 27.** The BOJ has decided to extend five-year loans against collateral to financial institutions again, which shows the resolution to suppress the wide expectation of short-term interest rate hikes after the bond yield rises too much. The 10-year Japanese government bond yield increased by BOJ's 0.5% cap on Jan 27th, followed by the newly released CPI hitting a 42-year high of 4.3%. The funds-supply tool was used to boost short-term funds and now is deployed to defend BOJ's recent yield control policy despite the inflation. (BT)

**IMF explores revived Pakistan bailout as currency hits record low** (WSJ)

**German finance ministry firmly rejects new EU common debt (**Reuters**)**

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