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Weekly Credit Brief Jul 7 - Jul 13 2020

COVID-19 and the oil price war put a spotlight on the high credit risk of Canadian oil and gas industry

by Tsoi Yuet Yan

COVID-19 and the Russia-Saudi Arabia oil price war have inevitably hurt the credit profiles of firms in the oil and gas industry. In our March Weekly Credit Brief issue, we highlighted the resultant heightened credit risk of junk-rated US oil and gas corporates. In this issue, our focus is on the severe deterioration of Canada domiciled oil and gas firms' credit profiles compared to that of global oil and gas firms. Canada domiciled oil and gas firms are more vulnerable to market shocks due to the nature of Canadian heavy crude as well as its undiversified buyer portfolio. Furthermore, the weak demand and price fall triggered by COVID-19 and the oil price war have led to falling profits and tighter cash flow of Canada domiciled oil and gas firms, exacerbating their refinancing needs. Moving forward, the industry's credit profile is expected to deteriorate further in the short run if no improvement is made to their business model.

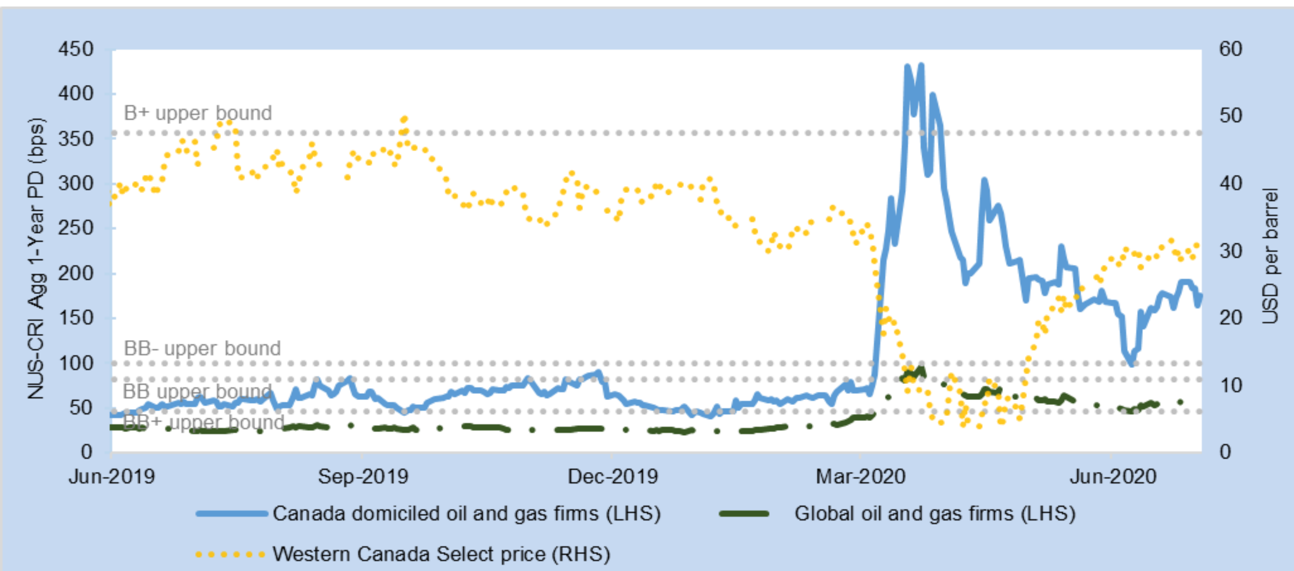

Figure 1: NUS-CRI Aggregate 1-year PD of Canada domiciled oil and gas firms and global oil and gas firms bounded by PDiR2.0 (LHS) and Western Canada Select Price (RHS) from June 2019. Source: *NUS-CRI, Bloomberg*

After the Russia-Saudi Arabia oil price war escalated and COVID-19 hampered worldwide demand for oil and gas in March 2020, WTI fell significantly below the breakeven price of Canada crude, which ranges from USD 55 to USD 75 per barrel. Canadian heavy crude - known as Western Canada Select (WCS) - is inferior in world markets due to the higher cost to process, refine and transport. Not to mention, the scarcity of pipelines (a result of political and regulatory restrictions) has forbidden access of Canadian producers to markets outside the US, giving the US bargaining rights as the main buyer of 96% of production. This translates to wide price discounts off WTI whenever the market is oversupplied or US demand slows (as it is the case today). Hence, benchmarked against WTI, WCS also fell accordingly. The Canada domiciled oil and gas firms' credit profiles, tracked by the NUS-CRI Aggregate (median) 1-Year Probability of Default (Agg PD) jumped from 82bps at the beginning of March to 431bps by mid of March, anticyclical to the change in WCS (see Figure 1). Within the same time frame, the Agg PD of global oil and gas firms increased relatively less from 46bps to 100bps. Corresponding to the increase in credit risks, the NUS-CRI Probability of Default implied Rating version 2.0 (PDiR2.0[1]) now shows that the Canada domiciled oil and gas industry lies within B+ boundaries while that of global oil and gas firms lies within BB boundaries.

One of the reasons for the higher credit risk of Canada domiciled oil and gas firms is the fall in profitability. In March, WCS fell 88%, from USD 35 per barrel to USD 3.80 per barrel by the third week of April. The crash of WCS coupled with major cities under lockdown caused demand to fall and the industry profitability to dip to its lowest in the first quarter of 2020 (see Figure 2a). Meanwhile, total revenue for Canada domiciled oil and gas firms also dropped by USD 8.4bn in the first quarter of 2020 (see Figure 2b). Furthermore, containment measures in 187 countries and territories that brought mobility to a pause had led to predictions that 2020 will see a fall in oil consumption of record 8.1mb/d, the biggest annual contraction in history. Unsurprisingly, Canada oil and gas firms are not exempted from this global trend - crude oil exports in Canada had plunged 55% (i.e., USD 3.6bn) in April. Canada's imports of energy products also fell by over 50% as Canadian refineries slowed down (or some even completely stopped) operations in April due to COVID-19.

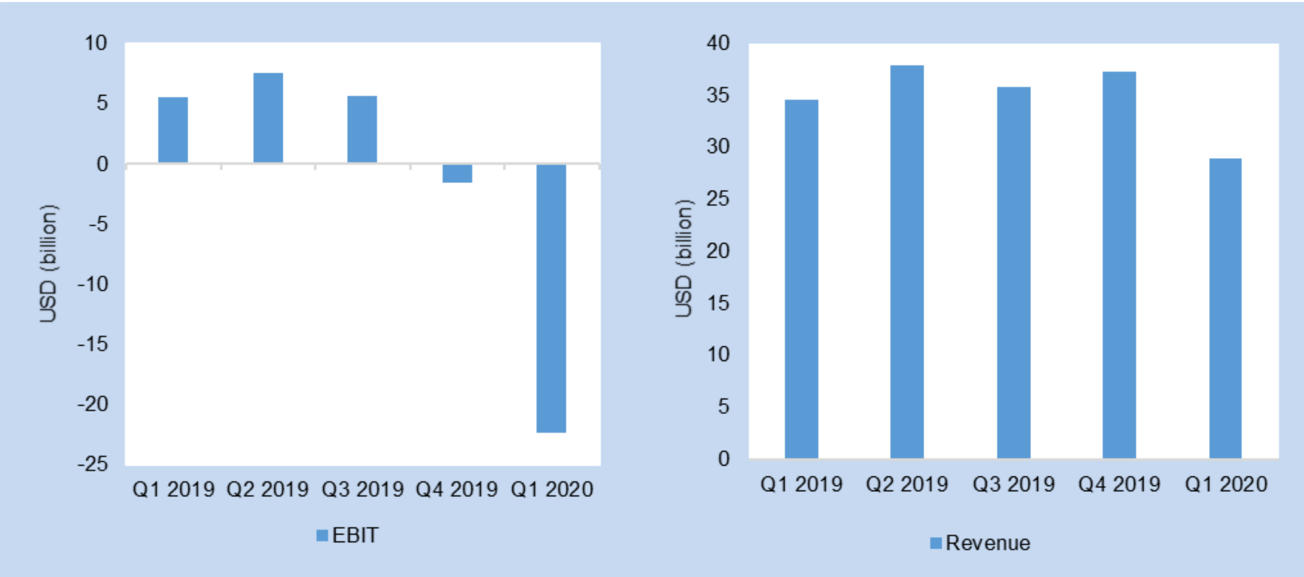

Figure 2a (LHS): Total EBIT (in USD billion) of Canada domiciled oil and gas firms from the first quarter of 2019. Figure 2b (RHS): Total revenue (in USD billion) of Canada domiciled oil and gas firms from the first quarter of 2019. Source: *Bloomberg*

The fall in profitability and cash flows does not augur well for this year's maturing energy debts which, according to Refinitiv data, recorded the highest in four years, a 40% surge over 2019. Furthermore, the liquidity position of companies has weakened with a median current ratio of 0.68x in Q1 2020 compared to 0.90x in Q1 2019. Refinancing is also likely to be a challenge for small and medium-sized firms because banks are no longer keen on holding energy assets, especially with the unpredictable oil prices. In addition, banks might also lower lending amounts as energy companies' borrowing bases (the total collateral against which they can lend) is projected to decrease by 20 to 40% on average according to analysts from The Royal Bank of Canada. Athabasca Oil Corp's banks had already cut its credit facilities by 65% while NuVista's credit facilities got cut by 14%. It is therefore not surprising that Bank of Canada believes the Canadian oil and gas industry faces the most potential downgrades in the coming six months.

Nonetheless, all hope is not lost when Prime Minister Justin Trudeau's government announced extra credit for large diversified energy firms as well as new loans and guarantees for small and medium energy firms. If the government carries through its plan, it means that the Business Development Bank of Canada (BDC) and Export Development Canada (EDC) will provide Canada domiciled oil and gas firms with access to the financing required to maintain its operations and keep their employees. Support will also be given to companies in the industry to sustain access to reserve-based credit. However, the strict criteria and limited details about the

[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.

funding have kept a cap on applications and there are no details on any firm that has received the benefits as of today.

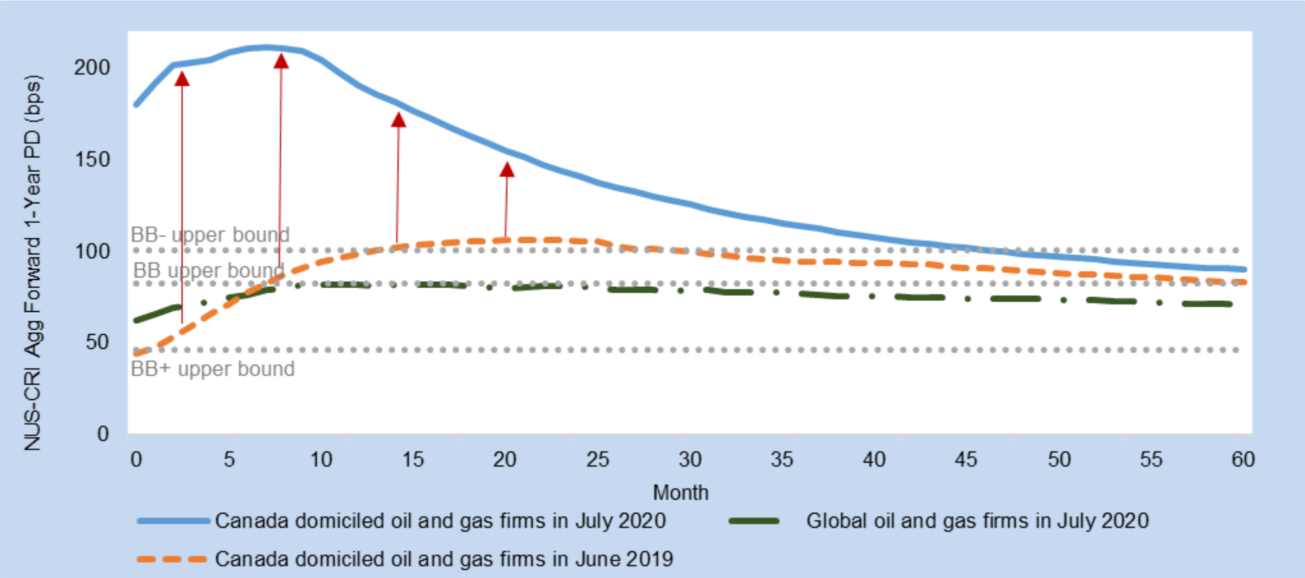

Figure 3: NUS-CRI Agg Forward 1-Year PD of Canada domiciled oil and gas firms based on information available in June 2019 and July 2020 and NUS-CRI Agg Forward 1-Year PD of global oil and gas firms based on information available in July 2020 bounded by PDiR2.0. Source: *NUS-CRI*

The NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[2]) in Figure 3 also shows that Canada domiciled oil and gas firms will continue to face a higher credit risk compared to their pre-March levels (82bps). The industry's Agg Forward PD based on the information available in July 2020 is upward sloping for the next ten months, with a steeper slope and higher absolute value compared to the Agg Forward PD based on information available in June 2019. From then on, credit profiles of the firms in the industry will gradually improve and converge to the pre-pandemic Forward PD. This is in line with economic projections that when global economies re-open, oil and gas demand around the world is expected to rebound. Compared with global oil and gas firms, the Forward PD of Canada domiciled oil and gas firms remain higher for the next five years, reflecting their inherently weaker business model. Moving forward, Canada domiciled oil and gas firms may need to restructure their business model and widen their buyer portfolio to increase their resistance to oil demand and price fluctuations.

[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar 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 1 year plus 6 months, conditional on the firm's survival in the next 6 months.

Credit News

Coronavirus bringing record USD 1tn of new global corporate debt in 2020

Jul 13. A study into the top 900 global firms by Janus Henderson revealed that companies around the world will have to take on up to USD 1tn of new debt in this year alone as they look to conserve capital and fortify their balance sheets after facing challenges from the Coronavirus. This will cause global corporate debt to soar to USD 9.3tn collectively, an unprecedented 12% increase. Initially, in March, lending markets mostly closed off as the virus hit global economies. However, due to corporate debt buying initiatives from central banks, USD 384bn of new high-risk debt was issued since the start of the year. The US itself currently owes almost half the world's corporate debt at USD 3.9tn with Germany a distant second at USD 762bn. (Jakarta Post)

US companies seeking capital during pandemic test bank market's new normal

Jul 11. Bank lenders for high-quality US companies are taking different refinancing avenues to extend maturities on billions of US dollars in loans as the Covid-19 pandemic has made liquidity a top priority. Currently, the investment-grade loan market grapples with tighter liquidity as a result of revolver drawdowns during the health crisis. Gilead Sciences, IBM and Ford Motor Co have tapped the market with transactions under different company-specific strategies, reflecting different lenders' perceptions of the credits and the changing of times. According to a debt capital markets analyst, companies are now positioning themselves to address immediate, short term liquidity needs and wait for further improvement in the bank market before they can go back to pushing out tenors and refining pricing. (Reuters)

Private credit lenders seek protection in minimum liquidity protocol

Jul 10. The pandemic has subjected the globe to an economic slowdown. Many companies are faced with increased leverage and fallen profits. In response, private creditors are implementing minimum liquidity covenants in credit agreements, which require businesses to have a certain amount of cash on hand, as a way to safeguard their investments. In doing so, lenders can enjoy the downside protection of having an early signal of financial troubles. This liquidity provision also provides borrowers with the flexibility to overcome the momentary financial strains. (Reuters)

Spain's BBVA breaks ground by issuing risky 'green' debt

Jul 8. Spain's BBVA managed to issue the world's first green AT1 bonds, the riskiest form of bank debt, which caused investors to question about how the money will fund sustainable projects. Despite BBVA's commitment to producing an annual report on the bonds, the historic lack of independent auditing or oversight of green bonds' use of proceeds has caused some confusion. BBVA's AT1 bonds were introduced after the financial crisis to support banks' balance sheets and could be converted into shares or written down if a bank needs to raise its capital. The head of research at Axiom Alternative Investments said that BBVA was able to take advantage of the guidelines in the green bond market, specifically to the requirements that allow a bank to originate more loans than the amount of capital raised. (FT)

Chinese developer fails to repay bondholders

Jul 7. Shenzhen-listed Tahoe Group Co. failed to repay yuan bonds amounting to USD 214mn on the 6th of July in what was the Chinese property sector's highest-profile default since 2015. The company was greatly affected by the property market downturn that was aggravated by the Coronavirus. Tahoe, which develops high-end projects in wealthy Chinese cities, cited its large debt, high financing costs and concentrated maturity of its debts as reasons for defaulting. The company has a further USD 840mn bond due in January, however, the credit ratings are already in "junk" territory and the bonds are trading far below face value, representing the market sentiment that the company is likely to default. Tahoe's default paints a picture of the struggling sector with financing problem further worsened by Beijing's move to limit funding to developers from the shadow banking system which Tahoe received 61% of its borrowings from. (WSJ)

Brazilian meatpacker JBS to buy back USD 875mn of bonds (Reuters)

LATAM Airlines adds USD 1.3bn to bankruptcy financing proposal (Reuters)

Japan first-half bankruptcies rise for the first time in 11 years (Reuters)

Regulatory Updates

Fed, Treasury disagreements slowed start of Main Street Lending program

Jul 12. The Main Street Lending program is geared to support businesses through the Covid-19 pandemic. So far, the Fed has taken the lead in drafting the USD 600bn program while Treasury has assumed the role of a checker. Between the two stakeholders, there is a divergence in their intended approaches. The Fed has a preference for looser terms. This would increase the risk of the government taking up more fiscal losses. Hence, the Treasury officials favored a more conservative route. Officials from both ends have come up to emphasize that the prolonged negotiations are necessary given the complexity of the Fed's corporate asset purchases. (WSJ)

SEC commissioner calls for better ESG labelling

Jul 12. SEC has called for asset managers to provide clearer information regarding the influence of environmental, social and governance (ESG) metrics on the performance of ESG-labelled funds. This means that there needs to be a detailed explanation for funds that are labeled as "ESG", "green" or "sustainable" and how these terms would affect strategy and objectives of these investment products. The call for more clarity stems from the risk of investors being misled by ESG ratings due to greenwashing, i.e., making a false impression about how investment products are in line with the claimed ESG concerns. (FT)

China's outstanding total social financing rises 12.8% y/y at end-June (Reuters)

IMF calls for global fiscal reform after coronavirus crisis (Reuters)

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