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Argentine companies' credit risk hinges on sovereign debt restructuring in short term and macroeconomic conditions in long term

by Liu Yuan

In our WCB published last August, we found credit profiles of Argentina domiciled firms were worsening since mid-2018, as Latin America's third-largest economy has been struggling with a long-lasting economic recession, high inflation and rapid depreciation in its currency (peso). This year, the country's Covid-19 outbreak in March further darkened its economic outlook resulting in a significant spike in credit risk (as measured by the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) in Figure 1). However, the credit risk of Argentine corporates has shown considerable improvement since late April amid the recovery of the financial markets and the high confidence in the market of loosening capital restrictions after a proper resolution in the sovereign debt restructuring. The confidence could also potentially be the driver for a fairly stable credit risk over the next two years. For now, Argentina is still working with its creditors to address the USD 65bn debt restructuring deal. Any failure to of the deal, however, could significantly change the credit risk of Argentina domiciled firms within a very short time period.

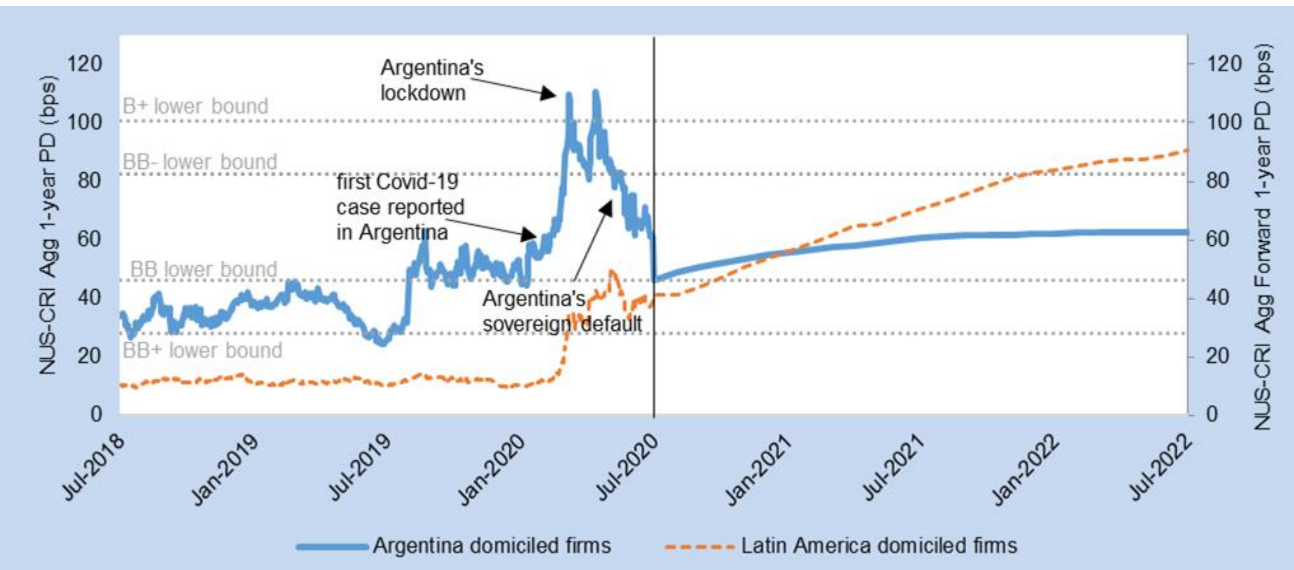

Figure 1: NUS-CRI Agg 1-year PD for listed companies in Argentina and in Latin America from Jul 2018, bounded by PDiR2.0[1] (LHS); NUS-CRI Agg Forward 1-year PD for listed companies in Argentina and in Latin America based on information in Jul 2020, bounded by PDiR2.0 (RHS). *Source: NUS-CRI.*

In Figure 1, the Agg PD of Argentina domiciled firms increased and reached its highest level since the 2009 financial crisis in Mar and Apr 2020. However, it presented a decreasing trend in recent three months and converged quickly to the Agg PD of Latin America domiciled firms. Furthermore, the credit risk of Argentina domiciled corporates will even be surpassed by their Latin America counterparts in the future, as indicated by

[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.

NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[2]). For listed firms in Latin America, the increase in their credit risk over the next two years is mainly driven by the worsening credit outlook for listed firms in Brazil, which is the biggest economy with the largest number of listed corporates in Latin America, due to the increasing rate of Covid infection in Brazil as well as the political uncertainty.

For quite a while, Argentine corporate borrowers have been caught in a very challenging macroeconomic environment. The sustained recession has come down hard on profitability (as demonstrated by the decreasing Return on Assets in Figure 2a), and the corresponding higher credit risk. The challenges are on account of long-lasting economic recession, high-interest rates, and runaway inflation, which was exacerbated by the coronavirus breakout. Already in the third year of recession, the economy is expected to contract by 12% this year. High borrowing cost is also a problem for them, as the country has one of the highest interest rates in the world. Despite cutting its benchmark interest rate eight times in three months to stimulate its weak economy, Argentina still has a high-interest rate of 38%. Besides, high inflation can also hurt the profitability of the companies. From 2017 to 2019, Argentina's inflation rate had increased greatly from 25.7% to 53.6%. Though having moderated since 2020, the inflation rate is still above 40% and jumped more than expected amid lockdown. To ease pressure on struggling households, Argentina has a long record of price controls. The new government had limited the commercial rates of basic services such as electricity and gas since last year and currently has no plan to remove the price control. Under this circumstance, Argentine corporates, especially those in the utility sector, would face a significant decline in profitability, and thereby heightened credit risk. As we can also see among the three sectors with the largest number of listed firms in Argentina, listed firms in the utility sector have the highest level of Agg PD and the biggest range during the past year (see Figure 2b).

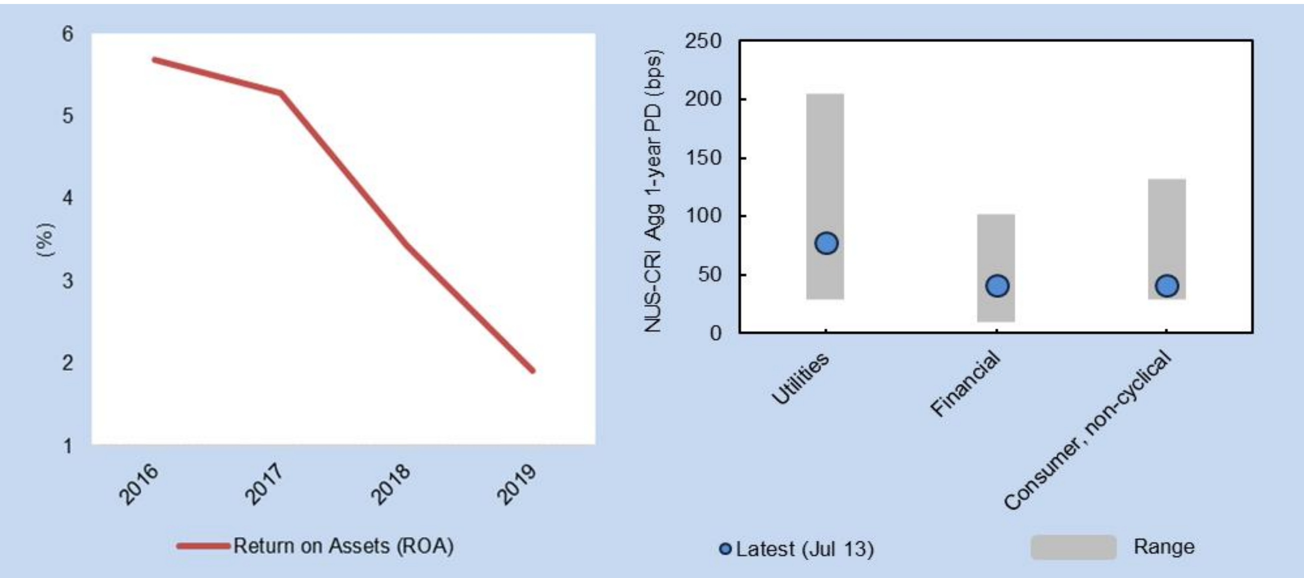

Figure 2a (LHS) Median Return on Assets (ROA) of all listed companies in Argentina; Figure 2b (RHS): NUS-CRI Agg 1-year PD for three sectors with the largest amount of listed companies in Argentina from Jul 2019 to Jul 2020 *Source: Bloomberg, NUS-CRI*

In a weak operating environment, we find that the outstanding amount of debts due this year is around USD 2bn and that for next year is about USD 3.8bn (see Figure 3a). It should be noted that a large portion of their debts is denominated in US dollars, which could expose them to foreign-exchange risk. In addition, their ability to repay USD denominated debts and interest expenses might also be affected by the government's attempts to reach an agreement with creditors this month on its USD 65bn sovereign debt restructuring. Since December 2019, the government announced currency controls to protect its international reserves. On May 28, 2020, soon after the nation's default, Argentina's Central Bank released the latest round of policy, limiting firms' access to the local foreign-exchange markets. Under the policy, companies are still allowed to pay their foreign currency debt obligations but have to first use their assets abroad before turning to Argentina's official currency markets.

[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.

However, if the government fails to finalize the deal, it could implement a stricter policy for access to foreign exchange. This, in turn, could result in an increase in the credit risk of Argentina-domiciled firms.

In the face of its coming foreign debt payments and stricter capital control, many Argentina-based firms try using swaps and local issuance to limit their risk. Argentina's leading real estate company Raghsa SA has successfully executed the swap offer of its USD 58.3mn notes due 2021 and 2024 for new notes due 2027. Argentina's biggest energy firm YPF SA has offered debt swap which would kick back USD 1bn in debt payments due 2021 to 2025, and many other firms may pursue similar debt exchanges. Argentina domiciled firms are also raising money through local issuances, taking advantage of its cheap pricing under the country's capital controls, though the deals are small in size and carry short tenors. Companies including oil and gas driller Pan American Energy LLC, shopping mall operator IRSA Inversiones y Representaciones, as well as renewable energy company Genneia SA have turned to the local market, and have all sold local debt in recent weeks.

While the government defaulted on its bonds, Argentina's corporates bonds remain attractive for the international investors, and among the best performers in emerging markets during the past months. The gains were driven by increasing confidence in a successful government debt restructuring and optimism about a resurgence in regional power and fuel demand as lockdowns ease. In Figure 3b, we show bond price information of some selected corporate and government bonds with similar term structure. Banco Macro SA and Telecom Argentina SA are among the top ten companies with the largest market capitalization, and Pampa Energia SA is one of the largest energy firms in Argentina. We find that Argentina's corporate bonds due around 2026 and 2027 have been traded higher than Argentina's sovereign bonds due Jan 2027 during the past year (see Figure 3b). However, corporate bond performance remains susceptible to the country's debt restructuring negotiations, and it also remains to be seen how long international investors will stand by Argentina's assets if the country continues to underperform.

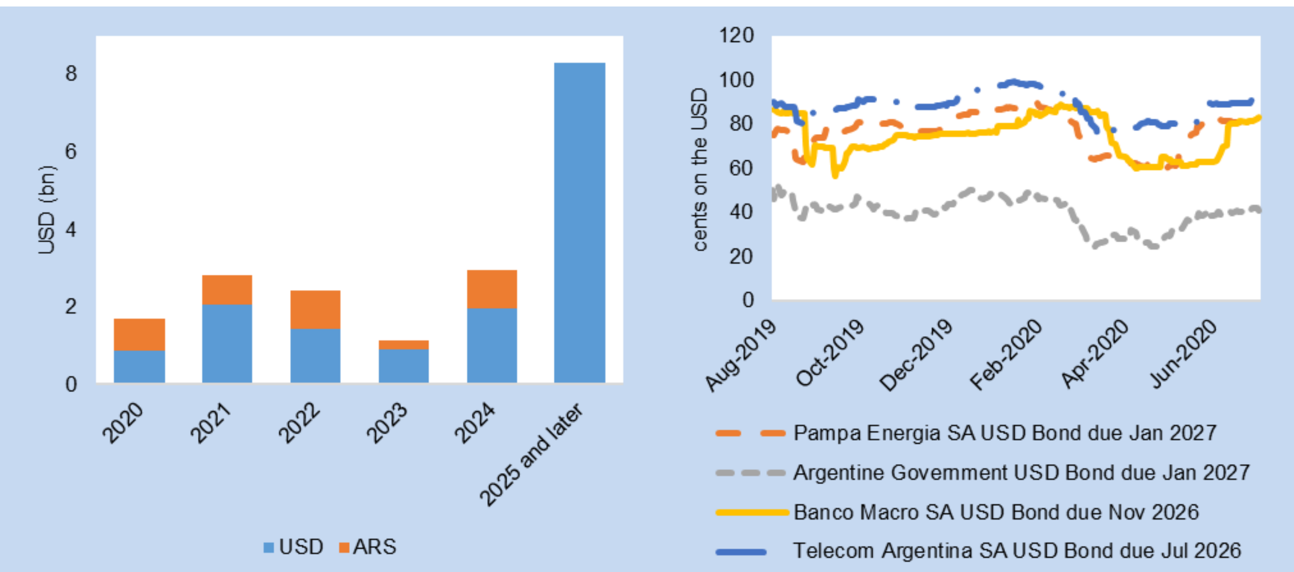

Figure 3a (LHS): Maturity of debts by currencies issued by listed firms in Argentina; Figure 3b (RHS): Bond prices for selected Argentina corporate bonds and government notes with similar term structures. *Source: Bloomberg*

Looking into the future, the credit risk for Argentina domiciled firms will increase but the level is relatively manageable. The current Agg PD and Forward PD trend seem to reflect the market's confidence of an amicable solution to the sovereign default, but uncertainty persists before the government finishes negotiation of its USD 65bn international debts restructuring in late July this year, and coronavirus clears. In the long run, Argentina domiciled firms still face challenges from unfavourable macro conditions which include economic contraction, high inflation and borrowing costs, as well as changing capital controls depending on the government's sovereign debt servicing situation.

Credit News

China's small lenders are filling up on riskiest bank debt

Jul 20. Chinese small lenders sold a record of USD 48.5bn perpetual bonds, one of the riskiest kinds of bank debt, to shore up their capital level amid an economic slowdown and rising default rates. An analysis by UBS Group AG stated that small lenders are facing USD 349bn of a shortfall in capital levels despite the country's financial regulator putting the figure at only USD 50bn. Several analysts are worried that smaller banks with tighter liquidity and weaker risk management capability might not be able to make interest payments or redeem the debt. Besides the debt market, smaller lenders are also tapping other channels, such as carrying out an initial public offering, to replenish capital. (Bloomberg)

Ecuador debt restructuring faces setback after some creditors balk

Jul 17. Ecuador, one of the poorest countries in Latin America announced in March that it was unable to repay all its debts due to the impact of Covid-19 and the oil price collapse this year. The country is now facing pressure due to disagreements with some of its creditors after presenting to them a USD 17.4bn debt provisional agreement backed by the holders of half of its bonds that would cut and stretch out the country's repayments. The creditors in disagreement account for more than 35% in certain bond series and they have counter-offered with a plan that would increase the country's average interest payments from 5.3% in the provisional agreement to 5.8% and ties the repayment cuts to Ecuador reaching a new lending deal with the IMF. (FT)

UK finance sector devices plan to tackle COVID debt pile

Jul 16. The CityUK Recapitalisation Group made up of over 200 top financial experts in Britain combined forces to design an initiative that helps small businesses restructure and repay USD 44.1bn in COVID-19 relief debt. The UK Recovery Corporation (UKRC) was launched by the group to offer manageable terms to borrowers and prevent bankruptcies which would be borne by taxpayers. Since businesses are expected to repay COVID-19 loans in March, EY analysts have projected that 780,000 SMEs might be in danger of insolvency in the third quarter once the government scheme tapers off. Under the proposal, the government will be the principal investor in UKRC initially but this debt is later sold off to private investors. Companies under the UKRC plan can access a "Business Repayment Plan" to convert state-backed loans below GBP 250,000 into means-tested tax liabilities. Ultimately, this would help prolong debt collection over a longer period and buy more time for firms to repay their debts. (Reuters)

Carnival taps bond market for another USD 1.3bn to stay afloat

Jul 16. Carnival Corporation sold another USD 1.3bn of "second lien" bond secured against its fleet of ships to steady itself while burning through more than half a billion dollars per month. It has previously paid a hefty price to raise USD 10bn of cash when it offered an interest rate of 11.5% on USD 4bn secured bonds backed by company assets. Although the financial situation of Carnival has made it fall into the 'junk' territory at BB+ according to the S&P Global, the new round of bonds attracted many investors, who valued the high return and give trust to the company based on its leading position in this industry. (FT)

China raises alarm on property bubble as 'high-risk shadow banking' returns amid virus lending push

Jul 15. China has been warned that the nation's rapidly growing property market might be in an asset bubble as credit has poured in to support the coronavirus-stricken real estate sector. Regulators are specifically concerned about the rising leverage in the corporate and household sectors as well as the return in shadow banking that has been used to fund inappropriate activities that drive up the asset bubble. This has seen the China Banking and Insurance Regulatory Commission (CBIRC) step up regulations to prevent the bubble from happening. However, analysts feel that the strong sale of real estate may not last till the end of the year as pressure on unemployment mounts and the rapid growth rate of credit likely starts to slow. (South China Morning Post)

Japanese banks see record demand for corporate loans during pandemic (Reuters)

California Resources files for bankruptcy protection (Reuters)

Bondholder group warns against adding coronavirus to EBITDA (Reuters)

Regulatory Updates

China integrates trading of USD 14tn local bond markets

Jul 19. The new policy was an attempt to address China's fragmented bond exchange environment. In doing so, the country aims to promote foreign participation in the Chinese economy. The new change enables traders to partake in both the interbank and stock markets by allowing intermediaries to connect issuance, trading and settlement. However, the root cause of the fragmentation remains. The bond market in China remains divided by 2 trading venues and 3 different regulators. (Bloomberg)

Fed opens 'Main Street' loan program to non-profits, eases terms

Jul 17. The Fed extends its pandemic safety net to nonprofits and this allows education, health, social service and other groups with a minimum of 10 employees to tap on central bank funding. The health crisis has inevitably caused a dip in charitable donations, school enrollment and participation in sports leagues. The Fed projects that this loan will help thousands of non-profits which accounts for 10% of US jobs. The official loan terms are still being developed but what is known is that the Fed will allow non-profits to get a bigger share of their revenues from donations and operate on slimmer margins. Non-profits will be subject to the same terms as companies under the Main Street program. (Reuters)

BOK starts lending through special purpose vehicle to stabilize local debt market (Reuters)

Egypt moves to widen local debt market access to foreigners (Bloomberg)

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