Weekly Credit Brief Jul 18 - Jul 24 2023

Headwinds remain despite the robust credit profile of the US oil and gas industry

by NUS-CRI Market Monitoring Team

- **NUS-CRI Agg PD shows that US oil and gas companies remained within the investment grade threshold in the first half of the year supported by lower debt capital position**
- **NUS-CRI Forward PD suggests that the credit profile of the industry may be threatened as oil and gas prices remain under pressure, in the face of recessionary headwinds and tightening credit conditions**

In the week leading up to July 21, the US oil and gas rig count, which serves as an early indicator of future output, declined by six, reaching 669, the lowest level recorded since Mar-2022. The possible effects of this rig cut might be in reference to OPEC's output cut which helped support the commodities' prices and allowed the US oil and gas companies to tap into demand from the Asian market. The NUS-CRI Aggregate (median) Forward 1-year PD (Forward PD[1]) as of Jul-2023 shifts down compared to that of Jun-2023, indicating the possible improvement of the industry's credit outlook. Besides, the O&G companies also managed to stay in a low-debt capital position during the past year, allowing the NUS-CRI 1-year Aggregate (median) Probability of Default (Agg PD) for the industry to stay within the investment grade threshold during the first half of 2023 when proxied against the PDiR2.0 bounds. However, the recessionary macroeconomic environment still casts a shadow over energy demand for oil and gas products, with the most vulnerable companies in the industry showing a more volatile credit profile. The Forward PD gradually rises and crosses the BBB- upper bound when referred to PDiR2.0 bounds[2], suggesting that potential unfavorable macroeconomic conditions might further erode the credit quality of the O&G companies.

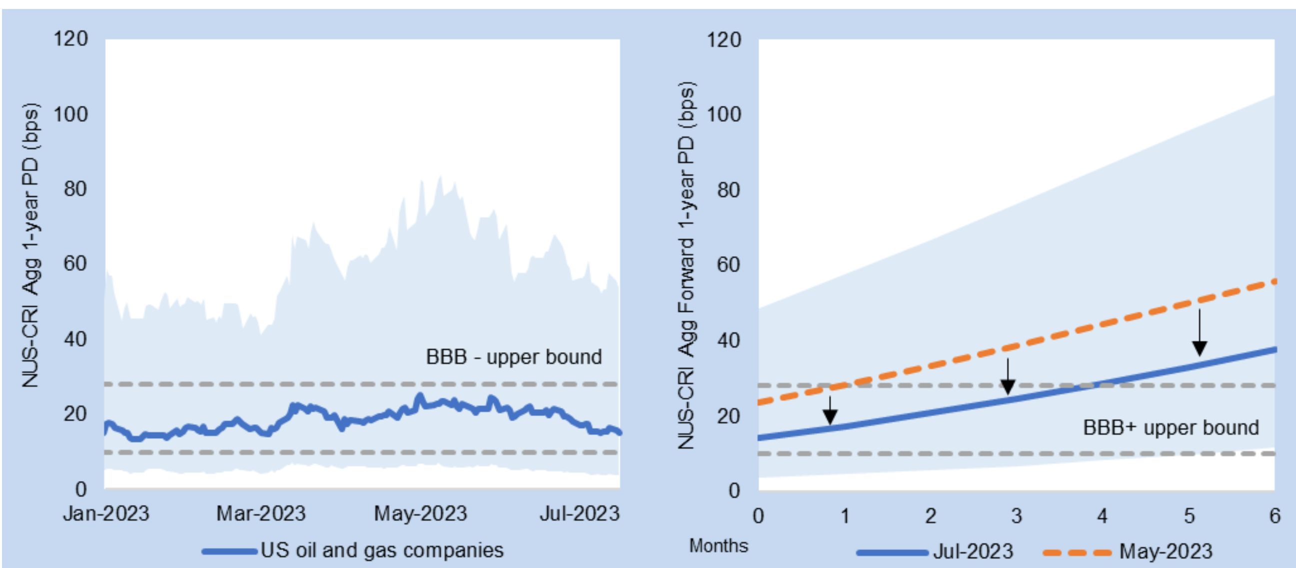

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for US oil & gas companies and the interquartile spread of the industry's Agg PD, with reference to PDiR2.0 bounds. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for US oil & gas companies as of May-2023 and Jul-2023, and the interquartile spread of the industry's Agg Forward PD as of Jul-2023, with reference to PDiR2.0 bounds. *Source: NUS-CRI*

[1] 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 18 months, 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 by 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.

A gradual slowdown in economic activities, mainly due to the recessionary headwinds and the consecutive rate hikes, has dragged the demand for oil and gas in the US. Along with the declining oil and gas prices (see Figure 2a), costs have emerged as an incessant hurdle for the US O&G industry over the past year as soaring inflation pushed operating expenses higher. Inflation-driven increases in costs, in combination with higher interest expenses and a large decline in oil and gas prices have contributed to the erosion of the industry's debt service ability over the past year. The interest coverage ratio and revenue growth (median) of the US O&G industry in our sample have been decreasing over the last four quarters (see Table 1). A silver lining for the industry is that the oil and gas companies have been using their operating profits to pay back their debts, deleveraging their balance sheet. The deleveraging exercise brought down the industry's debt to a comparatively stable level and may have mitigated pressures brought on by rising interest costs. Although the industry's debt serviceability remains strong, a decline in cash flow generation may contribute to a slowdown in production and may pressure liquidity levels, which may affect the credit profile of the most vulnerable companies in the industry that are already under distress with elevated credit risk profiles.

A potential tailwind to the US O&G industry's credit profile may be provided by the recent supply cuts by OPEC. Along with OPEC extending production cuts till the end of 2024, Saudi Arabia also announced additional production cuts. As a result, demand for US oil received a boost as Asian refiners booked near-record volumes of US oil for August delivery, possibly driving the improvement in the credit outlook as shown by the downward shift of NUS-CRI Forward PD in Jul-2023 as compared to Jun-2023 (see Figure 1b).

	Q2 2022	Q3 2022	Q4 2022	Q1 2023
Total debt to total capital	34.01%	32.38%	33.08%	30.15%
EBIT to interest expense	10.38x	8.3x	6.96x	5.98x
Revenue growth (YOY)	79.90%	51.04%	26.45%	11.36%

Table 1: Key financial ratios of US oil and gas firms. *Source: Bloomberg*

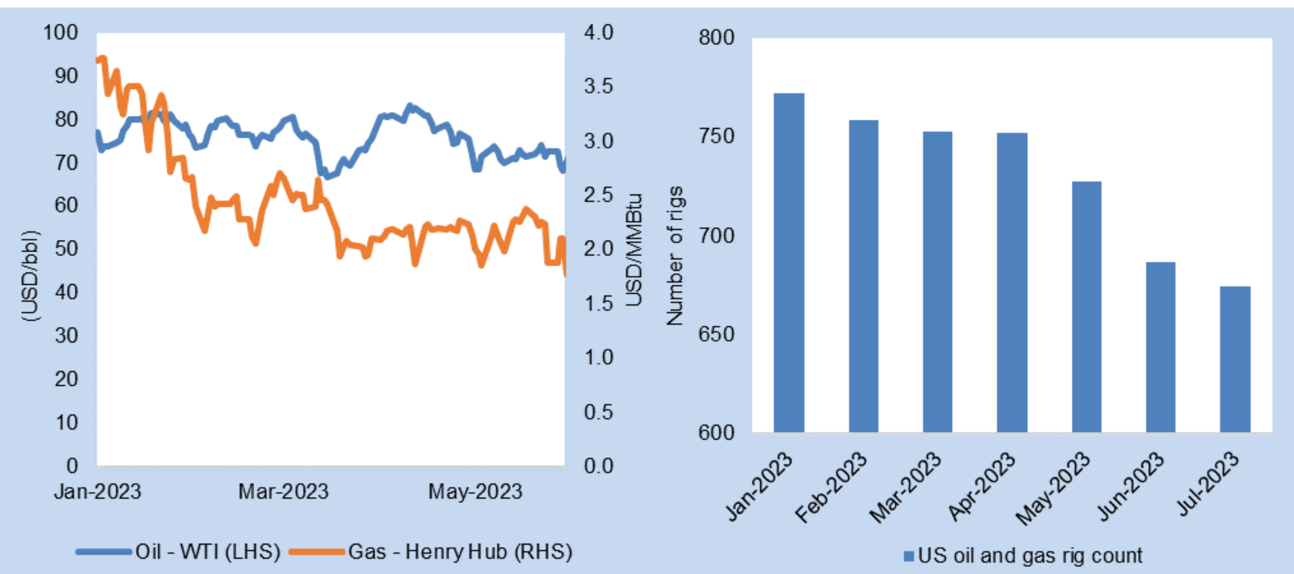

Figure 2a (LHS): US oil and natural gas spot prices from Jan-2023 to Jul-2023. Figure 2b (RHS): Number of US oil and gas rigs. *Source: Bloomberg*

The results from a recent survey by the Dallas Fed highlighted that the business activity index, which measures the conditions faced by 150 energy firms in the region, fell to 0[3] in the second quarter as opposed to 2.1 in Q1 2023, indicating stagnation. Possibly reacting to the recessionary demand outlook, the number of oil and gas rigs in operation decreased to 669 in the week ending July 21, the lowest since Mar-2022. This decline in rigs points to a future production pullback by US oil and gas firms. Furthermore, the Dallas Fed survey indicates that operating costs for US oil and gas firms may be higher by the end of 2023 as compared to the end of 2022. Against the backdrop of demand uncertainty, increasing costs may result in narrower profit margins. Besides, a

[3] The Dallas Fed Energy Survey creates an activity index based on survey respondents' business activity, employment, and capital expenditure amongst other indicators. The index value is calculated as the percentage of firms that are reporting an increase in business activity minus the percentage of firms that are reporting a decrease in business activity. For the index value to equal 0, the percentage of firms reporting an increase and the percentage of firms reporting a decrease is the same, suggesting falling activity.

continued downward trend in commodity prices as shown by the 33%[4] lower WTI crude oil daily average prices in Q2 2023 YOY and the 62%[5] fall of US benchmark Henry Hub in Q2 2023 YOY, may further worsen the firms' profitability. Demand for natural gas may also be threatened due to the expectations of a mild winter, similar to the one seen in 2022.

Falling rig counts, weakening prices, and increasing interest rates point to an impending slowdown for the US O&G industry. In addition to recessionary headwinds causing demand uncertainty, the industry may face additional pressure in the form of tightening credit conditions. Increased investor preference for environmentally conscious investments may have an adverse impact on the industry's access to financing as well as its cost of financing. This is especially relevant in the current environment where the US Fed has undertaken rapid interest rate hikes and may still have room to tighten rates further. The pressure may be acutely felt by the most vulnerable firms in the industry which may be disproportionately impacted, as shown by the widening interquartile spread of the industry's Forward PD in Figure 1b.

[4] Data from Bloomberg
[5] Data from Bloomberg

Credit News

UK banks lead global rivals in passing on interest rate benefits to savers

Jul 23. UK banks have outperformed their US and European counterparts in sharing the benefits of interest rate hikes with savers. As central banks raised rates to combat inflation, it improved the profitability of banks by increasing net interest income. UK banks, leading the cycle by seven months and facing higher competition, passed on 43% of the benefits to customers. In contrast, US banks passed on 25% of the Federal Reserve's rate increases, under greater pressure from competitive markets and product offerings. Eurozone banks have been slower to pass on benefits, with French and Luxembourg banks being more generous to customers. (FT)

Dalian Wanda bond uncertainty fuels high-yield trading volatility in Asia

Jul 20. Chinese conglomerate Dalian Wanda has triggered instability in Asian high-yield bond markets as investors speculate about the repayment of a USD 400mn bond due on Sunday. The bond's value surged 46% to 90 cents on the dollar on speculation of repayment, after fears arose regarding the group's cash reserves. This uncertainty compounds the unease in the market, already reeling from a series of Chinese property defaults since Evergrande's collapse in 2021. The average price of dollar junk bonds from Chinese issuers has declined to USD 0.68 on the dollar, undermining hopes for a market recovery supported by policymakers. (FT)

Care homes close as mortgage rate rises make businesses 'unviable'

Jul 23. UK care home operators are facing serious challenges due to a recent surge in mortgage rates and delayed government reforms, which could be detrimental to some providers. Data shows a decline in registered care homes, and rising interest rates are putting additional strain on the sector, exacerbating funding shortages and escalating expenses. The combination of staff shortages, Brexit, the pandemic, and soaring living costs has created a significant lack of resilience in the care industry. Some providers are at risk of closure, with limited access to funding from local authorities and the NHS crisis plan, while trying to handle increasing demand and financial pressures. (FT)

Exclusive: Struggling German property firms appeal to Berlin for multi-billion boost

Jul 21. The German property industry will seek multi-billion euro support from the government during a meeting with Chancellor Olaf Scholz on Sep 25th. The sector is facing its worst crisis in decades due to a housing shortage and collapsing prices, exacerbated by the end of cheap money that fueled a decade-long property boom. Representatives will request significant tax cuts and other measures to aid the struggling industry. Germany aims to build 400,000 apartments annually but has faced obstacles from historical factors. The president of the German Property Federation, Andreas Mattner, is urging the government to suspend the property sales tax temporarily and introduce low-interest rate credit programs for new residential buildings. (Reuters)

US junk loan market hit with flurry of credit rating downgrades

Jul 24. The US corporate loan market, worth USD 1.4tn, has experienced a significant increase in downgrades since the Covid crisis in 2020. In the second quarter of this year, there were 120 downgrades, amounting to USD 136bn, marking the highest total in three years. These downgrades are affecting companies that carry heavy debt loads with non-investment-grade credit ratings, as rising borrowing costs strain businesses with floating-rate debt. The surge in risky loans was fueled by low borrowing costs during the pandemic, but now companies face the challenge of repaying lenders with higher interest rates since the Federal Reserve began raising rates in 2022. The downgrades mean companies must pay more to issue new debt, and the riskiest loans could be shunned by the market's biggest buyers, collateralized loan obligations. This situation may limit financing for riskier companies, leading to higher-cost funding or potential defaults. (FT)

How U.S. drug companies could tip Europe into recession (WSJ)

China state-backed developers Greenland, Sino-Ocean in debt payment trouble (BT)

How debtors and creditors steered Carvana away from bankruptcy (FT)

Regulatory Updates

European central banks could speed up bond sales, say economists

Jul 23. European central banks are considering accelerating the reduction of their extensive bond portfolios to combat inflation and create space for future asset purchases during crises. While rate hikes have been used to tackle inflation, central banks like the European Central Bank (ECB) and Bank of England (BoE) have also been engaging in quantitative tightening to shrink their balance sheets. Economists believe that this process, which started last year, could be accelerated, particularly in Europe. Some experts suggest that ECB members may be willing to accept a lower terminal rate if it allows for faster quantitative tightening. While the pace of quantitative tightening is still up for debate, many are fearful that a quick turnaround in policy might impact the cost of borrowing for the government quite steeply, potentially causing conflict with fiscal policy. (FT)

Russian central bank surprises with sharper-than-expected rate hike to 8.5%

Jun 22. Russia's central bank surprised markets by raising its key interest rate by 100 basis points to 8.5%, surpassing analysts' expectations of a 50-basis-point hike. This move was taken to address inflationary pressures arising from a tight labour market, strong consumer demand, and the weakening rouble. It is the first rate increase in over a year. The bank also revised its year-end inflation forecast to 5.0-6.5% from 4.5-6.5% and left open the possibility of further rate hikes in the future. The central bank's governor attributed the inflationary pressure to rising domestic demand outpacing production capacity and a depreciating rouble causing higher import costs. (Reuters)

Turkey lifts rates for second consecutive month (FT)

South Africa calls end to long run of interest rate hikes (FT)

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