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South African companies facing multiple headwinds ahead

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South Africa's economy has been facing multiple headwinds on its road to recovery. The country has been affected by lower GDP growth and increase spending which includes support for state-owned enterprises (SOE) by preparing bail-out packages. Unemployment is also at a record 29 per cent which is piling on pressure on the government. This article aims to provide a corporate perspective on the state of the South African Economy through using the NUS CRI Probability of Default (PD) model.

The issues facing South Africa is also showing in 265 publicly listed companies which saw its PD double from 2018 to 2019. This increase in PD from 2018 to 2019 can be attributed to the sluggish economic growth as companies are facing weaker profitability and rising levels of corporate debt. If the economic growth continues at a slow-moving pace, highly leveraged companies would be vulnerable and would find it hard to meet their debt obligations.

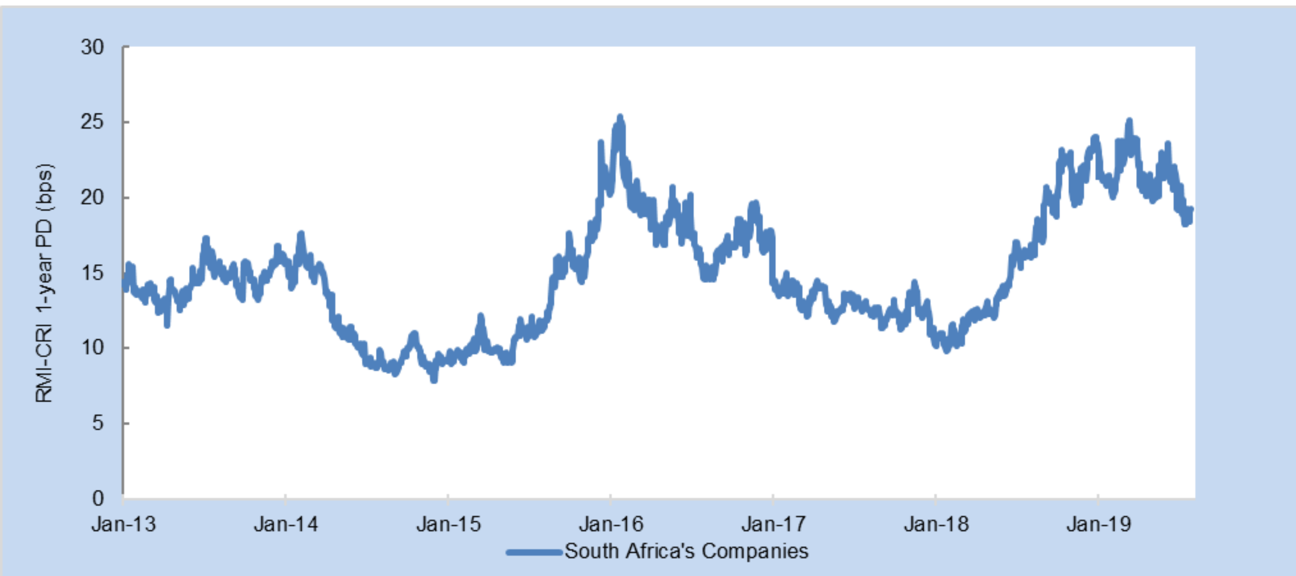

Figure1: NUS-CRI Aggregate PD for South Africa's publicly listed companies. Source: NUS-CRI

South Africa's GDP composition is mainly driven by the services sector which accounts for 70% of the nation's GDP, industry and agriculture accounts for 27.6% and 2.4% respectively. South Africa has been experiencing a sharp decline in GDP Growth since 2013 till 2018 as shown below. This slowdown could be attributed to multiple internal and external factors. The external factors affecting the slowdown could be attributed to a slowdown in Chinese demand for commodities and also the decline in commodity prices. Internal factors affecting GDP Growth can be attributed to a slowdown in productivity and financial constraints on corporate and household investment.

Figure 2: South Africa's GDP Growth Rate. Source: Bloomberg

South Africa government sector financial woes, with the recent bailout package of USD 4.2bn to troubled state power monopoly Eskom, have affected foreign investor's confidence. Foreign investors have been selling South African assets as a net USD 4.8bn of South African equities and bonds in 2019 have been sold, the most on a year-to-date basis since at least 1998. A silver lining for South Africa would be that the country still has room to maneuver as its corporate debt to GDP ratio is standing at 38% which is lower than countries such as Malaysia at 68% and Vietnam at 114% Debt to GDP ratio.

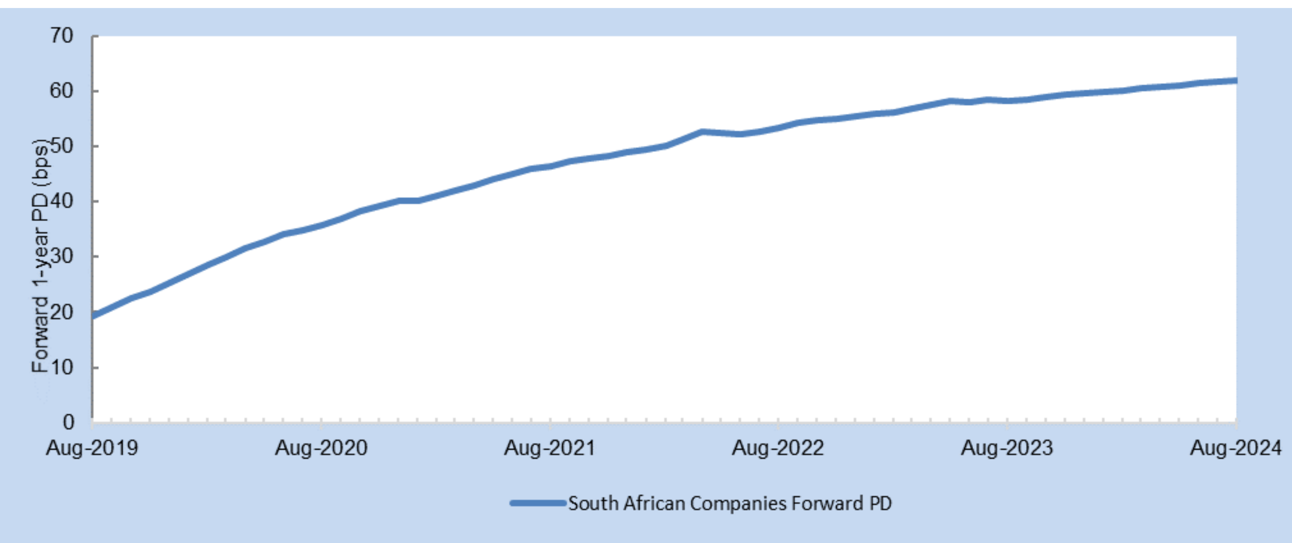

Figure 3: South Africa's publicly listed companies' Forward 1-year PD term structure. Source: NUS-CRI

The NUS-CRI Forward 1-year Probability of Default (PD) for South African publicly listed companies shows a steady increase. The Forward PD calculates the conditional credit risk the companies will face in the future. This could signify that the economy will be worsening in the coming years and it will affect the profitability of South African companies thus increasing the PD. In 2020, the Forward PD hits 40bps which translates to a BB+ using NUS-CRI Probability of Default Implied Rating (PDIR). This differs from the current rating cut by Fitch as they recently cut its credit rating for South Africa's Long-Term Foreign-Currency Issuer Default Rating(IDR) to negative from stable and affirmed the IDR at BB+. This difference in ratings could be attributed to the relatively low debt to GDP ratio of 38% and also a higher level of corporate debt issuance of USD 4.5bn this year compared to USD 2.8bn raised last year in the same period.

Credit News

For the first time ever, mortgage bonds are being sold at a negative rate

Aug 5. Jsyke Bank, a Danish Bank, is ready to offer 10-year mortgage bonds at a fixed rate of minus 0.5% in the world's biggest covered-bond market. It's the latest record to be set in a world that's being dragged down by ever lower interest rates amid uncertainty around the trade war, Brexit and the strength of the global economic upturn. Denmark has had negative central bank rates longer than any other country, as policy makers defend the currency peg to the euro. Denmark is also among a handful of sovereigns left that still boasts an AAA grade at the three main ratings companies, adding to its appeal in uncertain times.

Bond bonanza to help India battle world's worst bad loan ratio

Aug 2. India's benchmark 10-year government bond yield dropped about 50bps in July, extending past year's decline to more than 130bps. Each bp fall in the yield adds INR 3.5bn to banks' treasury gains, boosting their ability to writedown bad loans, estimates by ICRA Ltd. show. The windfall treasury profits come as a relief for lenders facing a potential surge in bad loan provisions due to a slowing economy and a cash squeeze in the country's shadow banking system. Adding to the optimism is the government's plan to infuse INR 700bn into state-run banks in the year to March 31 to strengthen their balance sheets and kick-start the nation's economic expansion. (Bloomberg)

China central bank keeps powder dry after Fed rate cut, but more easing expected

Aug 1. While the US Federal Reserve cut overnight benchmark rate on July 31, 2019, China's central bank kept its rates on hold as policy makers monitor the effect of earlier support measures. China's central bank has been quietly guiding borrowing costs lower since 2018, mainly through hefty liquidity injections. Last week, it shifted more funds into a lower-cost, medium-term lending scheme aimed at helping struggling smaller firms. While economic data has not been the strongest, officials fear easing too aggressively could fuel debt and financial risks. Climbing household debt and property prices have been a cause for caution for policy makers. (Reuters)

Businesses struggle for survival in US coal country

Jul 30. The Powder River basin of Wyoming and Montana, largest coal mining region in the US is in relentless decline, with bankruptcies sweeping across the area as electricity power plants burn far less than previously anticipated. Coal has lost market share in the electricity sector to natural gas and renewable fuels such as wind and solar. It now accounts for less than a quarter of total US generation, compared with almost 40% five years before. Trump's administration has introduced rules to help industry by allowing coal-fired power plants to run more frequently. However volumes have turned lower due to extreme weather conditions and low grade coal in these areas. The pace of decline has upturned businesses and a lot of them struggle to survive. (FT)

Cooling hedging costs take sting out of US-dollar debt investment

Jul 30. The US government bonds could soon attract more overseas investors as the sky-high cost of protection against dollar gyrations starts to recede. Since the Federal Reserve opened the door to interest rate cuts in April, the trade-weighted dollar has come under pressure, sliding from its most expensive levels in two decades. Markets are pricing in a 77% chance the Fed will cut its benchmark interest rate by a quarter of a percentage point when the central bank convenes this week, according to futures prices compiled by Bloomberg. Hedging costs have fallen as a result, but they remain elevated enough that many foreign buyers still face a loss when buying US Treasury debt. (FT)

China bond defaults rebound further in July (Bloomberg)

Aston Martin bonds shaken after credit downgrade (FT)

No-deal Brexit worries push Irish bond spreads to widest in over a month (Reuters)

Regulatory Updates

China central bank to take steps to improve banks' loan structure

Aug 2. PBOC said in a statement it will take measures to improve banks' loan structures, such as increasing the proportion of medium- to long-term loans for the manufacturing sector. Other measures include prohibiting consumer loans being used to illegally buy property, ensuring that loans flow to the real estate industry reasonably. The bank will also strengthen regulations on financing activities by big property developers with high leverage ratios. (Reuters)

UK's big banks told to publish 'living wills' from 2021

Jul 30. Big UK banks, including Lloyds banking Group and Royal bank of Scotland will have to publish their living wills from June 20121, alongside an assessment from the Bank of England (BoE) as to whether pass muster. All UK lenders with more than USD 55bn in retail deposits will be subject to the rules which is the same benchmark used for the BoE's annual stress tests of lender balance sheets. Unlike the stress tests, however, there will be no pass or fail judgement but a negative assessment by the BoE would likely be judged poorly by the markets. The increase transparency about the resolution regime is in the public's interest and also incentivizes firms to make further progress on their resolvability. (FT)

Trump's new tariffs may set stage for more Fed rate cuts (Reuters)

BOE chief warns messy Brexit would pressure global economy (WSJ)

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