Weekly Credit Brief Mar 23 - Mar 29 2021

US oil and gas industry's credit quality benefits from rising oil prices, though ESG concerns may pose a risk in outlook

by Raghav Mathur

- **As oil prices bounce back to pre-pandemic levels, the NUS-CRI Agg PD illustrates improving credit quality for listed US domiciled oil and gas companies**
- **The disproportionate impact of an increased leverage position on industry participants as well as ESG concerns could potentially restrict access to and increase costs of financing in the future**

The Biden administration has hit the ground running on combatting climate change. Not only did the administration re-join the Paris climate accord immediately after taking office in Jan 2021, but also vowed to revolutionize the energy industry by achieving a carbon pollution-free power sector by 2035, with the aim to become a carbon net-zero economy by 2050. The impact of these policies on US domiciled oil and gas industry could be profound, with potentially tougher regulatory standard pertaining to carbon pollution and greater scrutiny over the Environmental, Social and Corporate Governance (ESG) costs associated with the industry's business operations. Though the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) in Figure 1a demonstrates that the industry's aggregate credit risk has subsided to levels before the pandemic, predominantly due to the rally in oil prices, the industry is still battling the fallout of the pandemic-induced economic slowdown. NUS-CRI has recorded 72 defaults for listed US oil and gas companies in 2020. Furthermore, the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[1]) in Figure 2b indicates that weaker oil and gas firms still face disproportionately higher credit risk in the future.

[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 1 year plus 6 months, conditional on the firm's survival in the next 6 months.

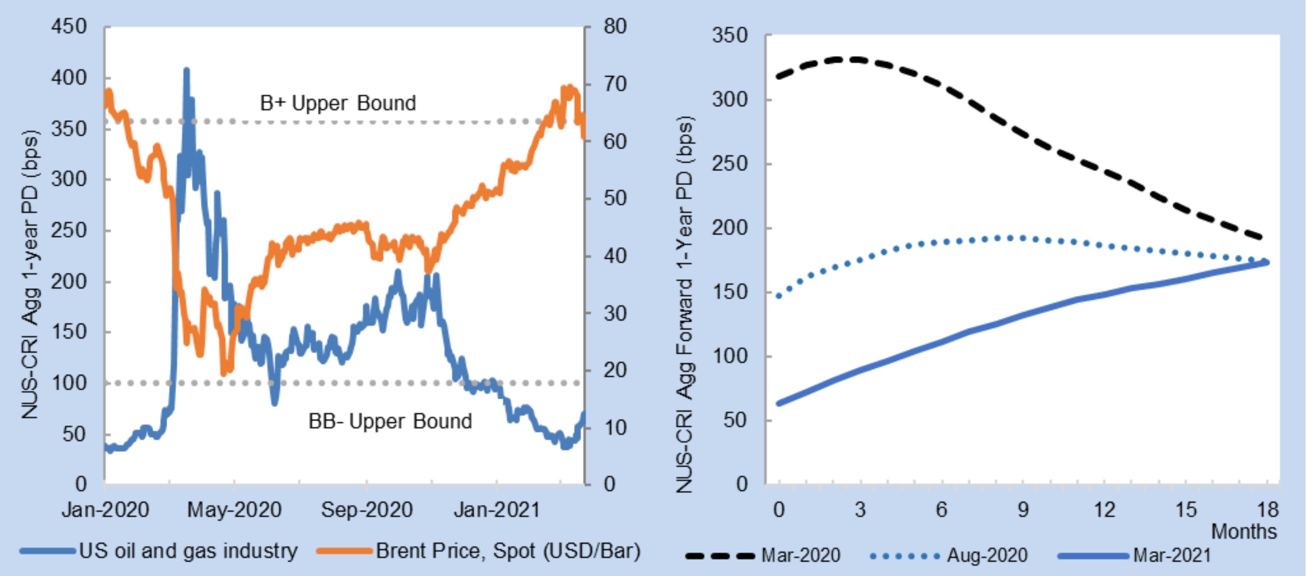

Figure 1a (LHS): NUS-CRI Agg PD for US domiciled oil and gas industry with reference to PDiR2.0[2] bounds; and the spot price for Brent Crude oil (USD/Barrel). Figure 1b (RHS): NUS-CRI Agg Forward 1-year PD for US oil and gas industry based on data feed as of Mar 2020, Aug 2020 and Mar 2021. *Source: NUS-CRI, Bloomberg*

The Forward PD in Figure 1b illustrates that the industry's credit outlook over the next 12 months has improved since the onset of the pandemic, with the Forward 1-year PD decreasing from 249bps in Mar 2020 to 148bps in Mar 2021. Suffice to say, one of the main drivers for the decreasing credit risk is the bounce back in oil prices over the past 12 months. As seen in Figure 1a, the price per barrel of Brent Crude oil reached USD 24 during the depths of the sell-off in Mar-2020. Concurrent with the recovery in oil prices[3], the Agg PD for the industry has come close to pre-pandemic levels of 63bps.

With the US Energy Information Administration (EIA) forecasting a 2 year-period for global oil consumption to reach the pre-pandemic trend of more than 100mn barrels/year, a rising leverage position may contribute to the rising credit risk for the industry if demand recovery takes longer than expected. Figure 2a below demonstrates the credit migration matrix for US domiciled oil and gas industry, with the proportion of companies with an S&P equivalent rating of B rising drastically over the next year to 62%[4], when mapped using PDiR2.0. The migration in PDiR2.0 also demonstrates worsening credit quality for IG companies, with virtually no companies having a forecasted PDiR2.0 value of AA or A.

The rising Forward PD based on Mar-2021 data feed shows that the industry is still facing elevated credit risk in the future. The pandemic has raised concerns particularly regarding the financial health of the weaker companies in this industry. From the breakdown of Forward PD into investment grade (IG) and non-investment grade (non-IG)[5] in Figure 2b, we witness a much worse credit outlook for non-IG companies when compared to IG companies. This may partially be attributed to higher leverage levels witnessed among non-IG firms. In 2021 so far, companies with non-IG ratings have issued more than USD 8bn in addition to the USD 33bn of debt issued in 2020. This increased the sub-group's median leverage position, with Total Debt/EBITDA increasing to 4.39 in Q4 2020, compared to 2.71 a year earlier. Though, IG companies' Total Debt/EBITDA also increased from 0.65 to 1.67 over the same period, the value is still lower than the industry median prior to the pandemic driven debt binge, which was 2.40 at the end of 2019.

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[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] Prices as of March 24th, 2021 reached USD 64/barrel.
[4] Interestingly, the industry does not have currently, or forecasted, companies listed in CCC rating or below, in tandem with the improving credit profile post the pandemic.
[5] Non-IG companies are those that are defined as having a PDiR2.0 rating of B+ and lower.

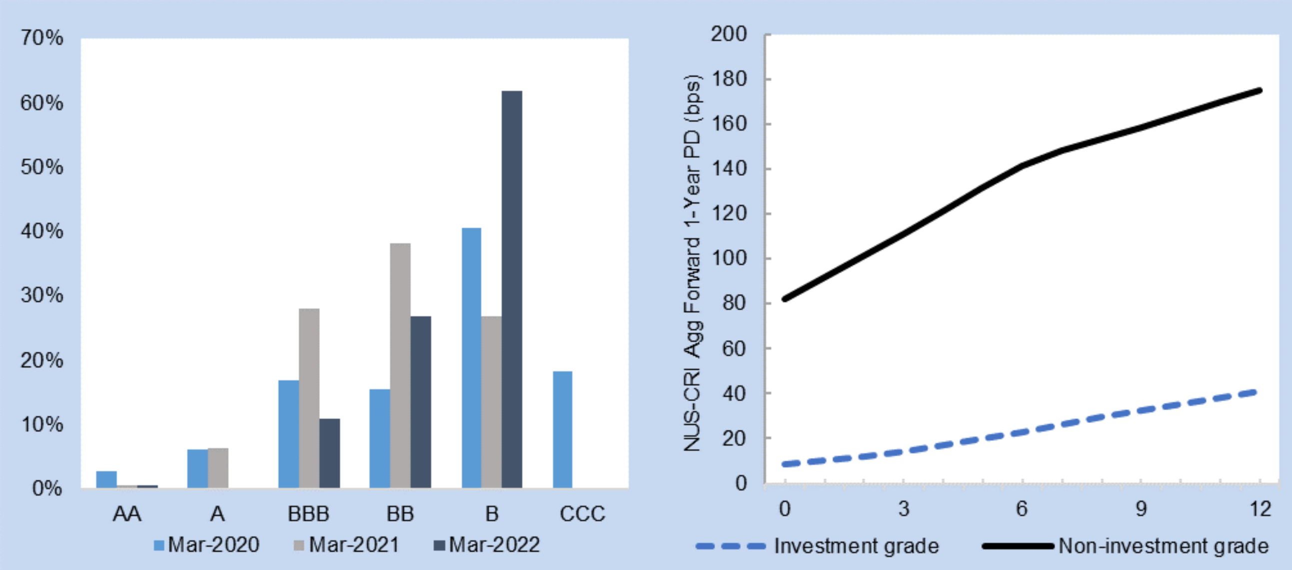

Figure 2a (LHS): Present (Mar 2021), past (Mar-2020) and forecasted (Mar-2022) credit distributions of the US oil and gas industry.Figure 2b (RHS): NUS-CRI Agg Forward 1-year PD for US oil and gas industry broken down into IG and non-IG based on data feed as of Mar 2021. *Source: CriAT and NUS-CRI*

Another possible driver for the worsening credit outlook are changing consumption patterns and the US government policies pertaining to climate change. The Biden administration has discontinued the subsidies provided to fossil fuel companies. Currently, the Environmental and Energy Study Institute estimates that the US government provides USD 20bn in subsidies to oil & gas firms in the form of tax breaks. New policies will aim to not only reduce the carbon footprint of individual firms by investing in new technologies that reduce carbon and methane pollution, but also incentivize companies to lean towards a larger renewable energy exposure in their operations. Resultantly, the largest US oil and gas trade group, American Petroleum Institution (API), has hesitantly backed the principle behind carbon-pricing and this might increase the cost of production across the industry. These changes may also be implemented through accelerating innovation in new technologies, such as carbon capture, utilization and storage (CCUS) facilities. While such initiatives may reduce the carbon pollution present in the incumbent operation systems, they will lead to increased R&D spending for US oil and gas companies in the short term. A silver lining may be that some firms could possibly drive this transition through green debt financing, which may reduce their borrowing costs.

Though the growth in fossil fuel consumption is unlikely to decrease drastically in the near future, consumption patterns towards renewables are likely to continue gaining momentum. Consumers and investors are becoming increasingly conscious about ESG implications, which may decrease access to financing and increase borrowing costs for traditional oil and gas firms. EIA forecasted that the proportion of energy consumption in the US that is coming from renewable sources is set to increase from 20% in 2020 to 23% in 2022. Given the increasing focus from investors and consumers on ESG, oil and gas firms that do not increase their exposure to green energy are more likely to face more hurdles when accessing debt capital markets in the future.

Credit News

Companies raise record USD 140bn in US junk bond market in first quarter

Mar 26. Over the past three months, companies have issued a record-high USD 140bn in the US junk bond market, leveraging on the low borrowing cost to fund acquisitions, pay dividends, and refinance existing debt. This is partially driven by the low interest rate environment which has prompted investors to look for higher returns in riskier assets. The high volume of new issuance expanded the size of the US junk bond market to USD 1.5tn from 1.2tn at the start of last year. Caution remains, however, as rising inflation expectations have begun to drag down bond prices including junk bonds.(FT)

With negative rates, homeowners in Europe are paid to borrow

Mar 25. Ever since the European Central Bank cut interest rates to negative levels in 2014 to combat a weak economy resulting from a sovereign-debt crisis, Eurozone economies were able to get cheap financing. The pandemic induced economic slowdown further caused rates to become lower. This has resulted in borrowers receiving interest on their loans from banks. According to Caixa Geral de Depósitos SA, 12% of its mortgages are holding negative rates, which is up 50% as compared to last year. Depositors in Denmark and other regions are now, however, being charged on their bank deposits instead. This happened as banks are now unable to cover the negative rates charged by the central bank. (WSJ)

Debt investors await more details on Biden's infrastructure plan

Mar 24. Despite the recent news that the Biden administration is planning for a USD 3tn plan for a multipart infrastructure and economic package, yields on US treasuries have surprisingly paused. Increased government spending can increase Treasury yields by boosting economic growth and increasing the supply of bonds. This year, Treasury yields have already increased sharply due to expectations of higher growth and the announcement of a large coronavirus relief package. Possible reasons for the relatively muted response in the bond market include investors waiting for more details about the spending plan and being skeptical about its chances of making it through Congress. (WSJ)

China warns regional banks to brace for tidal wave of bad debt

Mar 24. China's small regional banks are facing a potential surge of nonperforming debt as the debt servicing waiver, which is part of China's coronavirus stimulus package, is set to expire at the end of this month. Should the debt payment relief come to an end, the Chinese banking industry could be saddled with an additional CNY 700bn of bad loans this year. Financial regulators are becoming increasingly vigilant and the country's five-year plan through 2025 contains a provision to improve the mechanism for identifying and disposing nonperforming loans. Its goal is to prevent uncertainties from the global economy from spilling over into its country's financial system. (Nikkei Asia)

Turkey's money markets face 'liquidity squeeze' after lira tumble

Mar 23. The firing of Turkey's central bank chief rattled the country's money market, with the overnight swap rate reaching an annualized amount of 1,400%. This means that investors would not be able to hedge against lira-denominated assets. The liquidity crunch came about as investors rushed to leave the Turkish market. The lira fell as well, ending at a 7.4% drop. The slowdown in the money market would likely have been caused by local banks and may be risky for foreign investors that hope to close positions in the country. The capital control measures would likely hurt the country's reputation as a potential destination for foreign investment. Its main equity index, the Borsa Istanbul 100 lost around 10%, while the Turkish banking index fell by 15%. (FT)

Eurozone banks have enough capital to withstand pandemic hit - IMF (Reuters)

Chinese developer Kaisa plans to partly fund USD 2bn property buy via rights issue (Reuters)

Greensill Capital files for bankruptcy protection in New York (Reuters)

Regulatory Updates

Ditch Libor on time or lose your bonus, Bank of England tells bankers

Mar 26. Bank of England warned bankers to ditch the London Interbank Offered Rate (Libor) interest rate benchmark by end of this year or they would lose their bonuses. Libor, which is going to be replaced by the overnight Sonia rate, used to be one of the world's most important benchmark rates and there are currently still USD 260tn worth of mortgage or business loans priced off Libor. Each bank has to nominate a senior manager to oversee the process and their variable numeration will be partially based on the transition. (Reuters)

Bank of Japan eyes shift to 'hands-off' approach on bond buying

Mar 26. Bank of Japan (BOJ) will move to a more hands-off approach in its bond-buying operations. BOJ stated that it would now allow 10-year bond yields to fluctuate within a 50bps range around its target of 0%. Furthermore, it will also provide the specific amount of bonds purchased for each maturity starting from its bond-buying schedule for April. These new practices would allow market forces to drive moves more and receive more predictability. BOJ continued to stress that its priority is to keep the entire yield curve "stably low", implying that it would not tolerate any rise in 10-year yields above 0.25%. (Reuters)

South Africa's record low lending rates 'won't last forever' – central bank governor (Reuters)

Colombia central bank likely to hold rate yet again at 1.75% (Reuters)

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