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Indonesia's palm oil export ban threatens credit risk outlook for palm oil producers

by Elaine Uy

- **NUS-CRI Agg Forward 1-year PD indicates that the credit health of Indonesian export-centric palm oil producers may deteriorate, potentially to levels seen in Q2 2021, due to hindered production capabilities and rising input costs**
- **The palm oil export ban imposed by the Indonesian government could stress the Indian packaged food manufacturers' profitability in the short-term**

Indonesia has implemented a ban on the export of palm oil from Apr 28th, 2022 in an effort to reduce its domestic shortage. The sudden surge in global oil prices, which was accentuated by Russia's invasion of Ukraine[1], and the resultant increase in global demand for palm oil should have mapped a continuous recovery for Indonesian palm oil producing companies. However, ineffective government policies that were aimed at controlling rising prices triggered the domestic supply shortage. Moreover, the surging global oil prices motivated the export-centric Indonesian oil producers to shift their inventory, including the minimal inventory earmarked for domestic consumption, for sale to foreign markets to maximize revenues, positively impacting their credit risk profiles (See Figure 1a). The NUS-CRI 1-year Agg (median) Forward PD (Forward PD[2]) showcases a deterioration of credit health for Indonesian palm oil producers exposed to factors such as rising input costs, unfavorable weather, and labor shortages. Indonesian export centric producers, however, exhibit a marginally steeper slope as compared to domestic-centric producers due to the additional regulatory pressures on profitability (See Figure 1b).

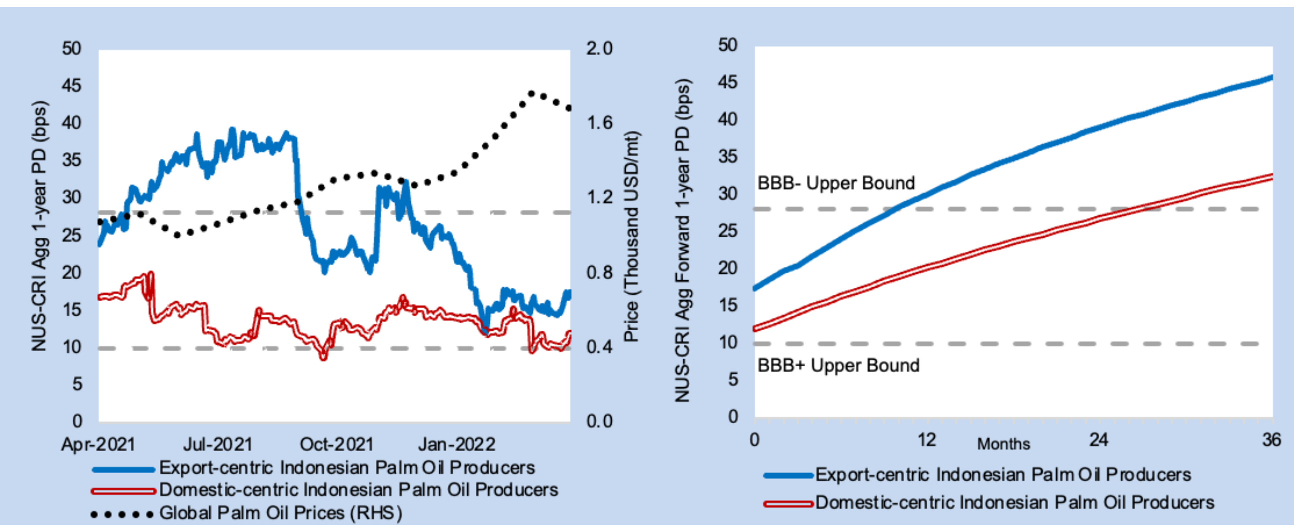

Figure 1a (LHS): NUS-CRI Agg 1-year (median) PD for Indonesian palm oil producers which primarily cater to foreign markets vis-a-vis the domestic market[3] from Apr-2021 to Apr-2022, with reference to PDiR2.0 bounds[4]; Global palm oil prices (RHS) (thousand USD/mt). Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Indonesian palm oil producers which primarily cater to foreign markets vis-a-vis the domestic market with reference to PDiR2.0 bounds, as of Apr-2022. *Source: NUS-CRI,* YCharts

Global demand for palm oil has been on an uptrend since 2020, driven by an uptick in demand from China and India that has benefitted Indonesian palm oil producers. In addition, Indonesia's domestic demand has been

[1] Palm oil, a key ingredient for food manufacturers globally, has recently become more expensive following Russia's invasion of Ukraine, the two largest exporters of sunflower oil.

[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly 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 – this is conditional on the firm's survival in the next 6 months.

[3] Export-centric oil producers are those that derive a substantial portion of their revenues from export sales, as disclosed in their most recently available annual reports; while domestic-centric oil producers are those that mainly sell to local consumers.

[4] 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.

booming due to the government's mandate[5] of blending at least 30% of palm oil in biodiesel production, aimed at reducing the country's dependence on imported diesel. However, aging palm trees across Indonesia hinder growth in production levels, despite the replantation programme started by the Indonesian government in 2017. New plantings have seen a slowdown due to limited agricultural land, unfavorable weather conditions, and labor shortages, especially during the pandemic. Even worse, output in H2 2021 had further decreased due to floods which disrupted palm fruit harvesting. As such, despite rising demand both domestically and internationally, palm oil producers may not be able to service it until supply shortages[6] are eased.

Lower production amidst rising demand should have allowed palm oil producers to increase their prices to absorb the heightened input costs. However, the ability of Indonesian palm oil producers to adjust prices reasonably to preserve margins is hindered by government intervention. Global palm oil prices registered a record-high in Oct-2021, creating an opportunity for Indonesian palm oil producers, who mainly cater to the foreign market, to recover costs and allocate more of the palm oil production for export, contributing to scarcity in the domestic market. Consequently, local prices of palm oil surged by 40% YoY, prompting the government to deploy price-stabilization measures. To ensure domestic availability of supply and contain prices, the government imposed successive bans on exports of crude palm oil. As such, Indonesian palm oil producers that are export centric are likely going to face heightened pressures on their cash-flow generating ability from their export-driven operations, which may impact their bottom line moving forward, possibly worsening their credit risk outlook compared to their domestic-centric peers (See Figure 1b).

Indonesian oil producers' potentially hindered profitability due to low production yields, rising input costs and strict government price regulation policies, could also pressurize the industry's ability to service its debt obligations, potentially forcing them to refinance or raise additional liquidity; especially in a scenario where the export ban continues to have a prolonged hindrance on the industry's top line. Though the industry has relatively low leverage, and only about 38% of the industry's debt is maturing within 1 to 2 years, the export ban from the Indonesian government, in addition to the industry's domestic production risks, may raise potential concerns regarding the long-term debt servicing capability of the whole industry, especially for those palm oil producers that are export-centric (these companies have close to 45% of their debt outstanding maturing before 2025) (See Figure 2a).

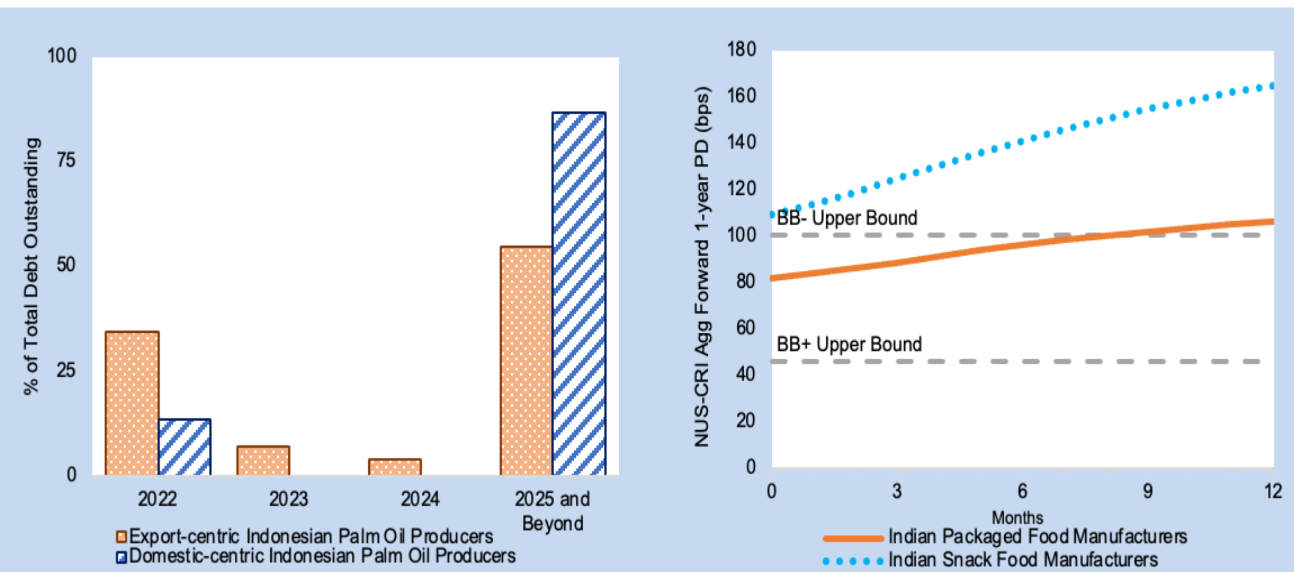

Figure 2a (LHS): Debt maturity profile of Indonesian palm oil producers. Figure 2b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Indian Packaged Food Manufacturers and Indian Snack Food Manufacturers as of Apr-2022, with reference to PDiR2.0 bounds. *Source: NUS-CRI, Refinitiv*

Indonesia's export ban on palm oil will most likely impact India, the world's largest importer and second-largest consumer[7] of palm oil, which imports 90% of its palm oil demand for use in its fast-growing packaged food and snack manufacturing industry. In 2021, Indian packaged food manufacturers enjoyed stable margins as the government took several measures to moderate the increase in palm oil prices. However, sustained profitability is threatened by the disruption in supply chains which dually impacts both costs and demand. Should the ban

[5] The Indonesian government's direction towards achieving 23% renewable energy use economy-wide by 2025 and 31% by 2050 drives biofuel production which increased by 9% YoY in 2021.

[6] Palm fruit farmers' reduced usage of fertilizers and pesticides due to their surging prices, as well as limited the use of freight services due to rising costs, resulted in the sluggish yields of palm oil compared to previous years.

[7] Palm oil is preferred in India by the food industry as it is relatively cheaper, lasts longer and is more stable at high temperatures.

be extended, the margins of Indian packaged food and snack manufacturers could decrease and effectively affect their liquidity position. Moreover, the resulting runaway global inflation which significantly influenced consumer prices could be further inflamed by the ban, potentially shifting consumption patterns towards more staple and affordable food, and damaging demand for Indian snack food. Considering the current supply chain pressures, credit risk for Indian snack manufacturers is expected to be heightened in the short term as shown in Figure 2b.

The objective of the ban on the export of Indonesian palm oil is to resolve the domestic supply shortage that sent local market prices soaring and caused public unrest. Yet, the policy restricts the ability of the Indonesian palm oil manufacturers to maximize profits, especially amidst the rising global edible oil prices, which could have been an avenue for the Indonesian oil producers to offset the production woes that they have faced previously. Moreover, while it extinguishes domestic inflation, it also fuels global edible oil prices as it creates another disruption to the supply chains. Likewise, the export ban directs demand towards Malaysia, the second-largest producer of palm oil, subjecting Malaysian palm oil producers to immense pressure to compensate for the lost inventory. However, in the face of similar challenges as Indonesian oil producers, Malaysian oil producers may not be able to fill the supply gap.

Credit News

Distressed debt levels double in US corporate bond market

May 4. The total value of bonds trading at distressed levels has increased to USD 27bn from USD 14bn in Dec 2021, signaling investors' retreat from risky debt. This deterioration of bonds to distressed levels is driven by the hawkish pivot of the Federal Reserve as it tries to control rampant inflation by implementing a series of rate hikes. The hawkish stance by the Fed along with slowing global growth and the Russia-Ukraine war may increase the credit risk of highly leveraged companies as refinancing risk increases. With further rate hikes expected in the coming months, more debt may be pushed into the distressed territory. (FT)

U.K. housing market outlook dims with jump in borrowing costs

May 7. Soaring housing prices coupled with a higher cost of borrowing in the UK market is projected to have adverse impacts on consumers in the upcoming years with lower-income families being the hardest hit as they prefer rentals over owning a house. Housing prices are up 80% since 2008 and have resulted in UK consumers racking on more debt to afford payments for the house. An increase in interest rate can certainly help soothe the growth of prices, however, mortgage owners would face pricier debt repayment options. Most UK mortgage holders are yet to feel the cost crunch as longer-term fixed-rate home loans have been the new preferred choice during a time of rising borrowing rates. However, the higher financing costs will seep through in due course as the deals expire at the end of the term. (FT)

Cost of default hedges in Europe tops level last seen in 2020

May 9. A European high-grade credit default swap index, which is an index of CDS for investment-grade companies has seen its spread surpass 100 bps for the first time in two years. The debt of European corporates has been bearing the brunt of a slowdown in the economy and soaring inflation. Average spreads of euro-denominated investment-grade debt stand at 154 bps and the debt has been facing 6 consecutive months of total return losses. Even as central banks take action to curb inflation, the heightened risk has curtailed new issuances of corporate debt. (Bloomberg)

Asian lessors take losses on failure to recover jets from Russia

May 3. The Russia-Ukraine war has placed aircraft leasing companies in a capricious position as EU sanctions have forced lessors to break leases with their Russian counterparts while their aircrafts remain stranded on Russian lands. Furthermore, the situation has been exacerbated as Russia has retaliated by signaling permission to local airlines to appropriate the abandoned airplanes. As the chances of recovery of these aircraft remain slim, Aircastle and Avolon holdings have begun writing off $550m worth in assets which consists of 10 planes, and face deepening net losses. Other Asian lessors such as BOC Aviation, and CDB Aviation plan to follow suit by writing-off the forgone assets but hope for the situation to improve with time. (Nikkei Asia)

ECB policy tightening sends eurozone borrowing costs soaring

May 4. Eurozone's tightening of monetary policy to curb inflationary pressures has resulted in higher borrowing costs reflected by a 1% hike in Germany's 10-year government yield bond and an anticipated rise in interest rates in the near future. However, Italy faces a worse risk profile than its EU peers owing to its large debt-to-GDP ratio, falling GDP, and political instability with the anticipated departure of Mario Draghi hence, is expected to face higher borrowing costs which would further worsen its financial profile. Accordingly, the Italy-Germany 10-year yield spread has increased to new highs since 2021 signaling higher risk premiums commanded in the Italian economy, and the spread is projected to widen in the future as the tightening measures remain in effect. (FT)

ESG debt sales hit eight-month low as volatility deters issuers (Bloomberg)

Swiss Re pushed to loss as reinsurers count cost of Ukraine war (FT)

Yen credit escapes sharp selloff seen for Asian dollar bonds (Bloomberg)

Regulatory Updates

Australia's central bank drastically raises inflation forecasts, flags more rate hikes

May 5. Australia's central bank recently revised its forecast to reflect higher inflation, indicating a possibility of multiple rate hikes in the near term as it tries to bring inflation in control. The quarterly statement of RBA forecasts that core inflation may reach 4.6% by the end of 2022, an increase from its forecast in Feb 2022. The forecasted inflation level is well beyond the 2-3% target band set by the RBA and it is forecasted to return to within the target band as late as mid-2024, signaling a series of rate hikes in the near future. With employment at multi-decade lows and an increase in annual wage growth, the case for rate hikes becomes even stronger. (CNBC)

India's central bank raises interest rates for first time since 2018

May 4. India's sensitive consumer and financial markets have faced persistent inflationary pressures due to rising commodity and fuel prices following the Russia-Ukraine war which has hurt import centric firms and foreign investment. In response to the consumer inflation index exceeding target rates, the Reserve Bank of India announced an interest rate rise of 40 basis points to curb the inflationary pressures. However, the unprecedented response of the central bank was met with conflicting sentiments as it fostered uncertainty regarding future interest rates in the Indian financial market. (FT)

BOE sees risk of U.K. recession with inflation above 10% (Bloomberg)

ECB defies global peer pressure after Fed-led tightening (Bloomberg)

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