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Faster credit quality deterioration for Indonesia corporates with foreign currency denominated debt amid the COVID-19 pandemic

by Anthony Prayugo

Just like the majority of other corporates in the world, Indonesia domiciled corporates have been badly hit by the current COVID-19 pandemic and they are facing higher funding costs under the worsening global economic conditions. Those non-financial corporates that rely heavily on foreign currency-denominated debts, in particular, have been suffering an even worse credit quality deterioration on account of the local currency depreciation (IDR) and weak foreign investors' sentiments. Amid the current global economic uncertainties, foreign investors, who play an important part in the Indonesia financial markets, fled from emerging markets for safe-haven assets, driving the USDIDR[1] level at one point last month to its weakest since 1998. The NUS-CRI Aggregate (mean) 1-year Probability of Default (Agg PD) below supported the assertion that true enough, the credit profile of Indonesia domiciled non-financial corporates with foreign-currency denominated debt deteriorated more rapidly amid the current pandemic. Furthermore, the short term credit outlook for these corporates is also expected to deteriorate.

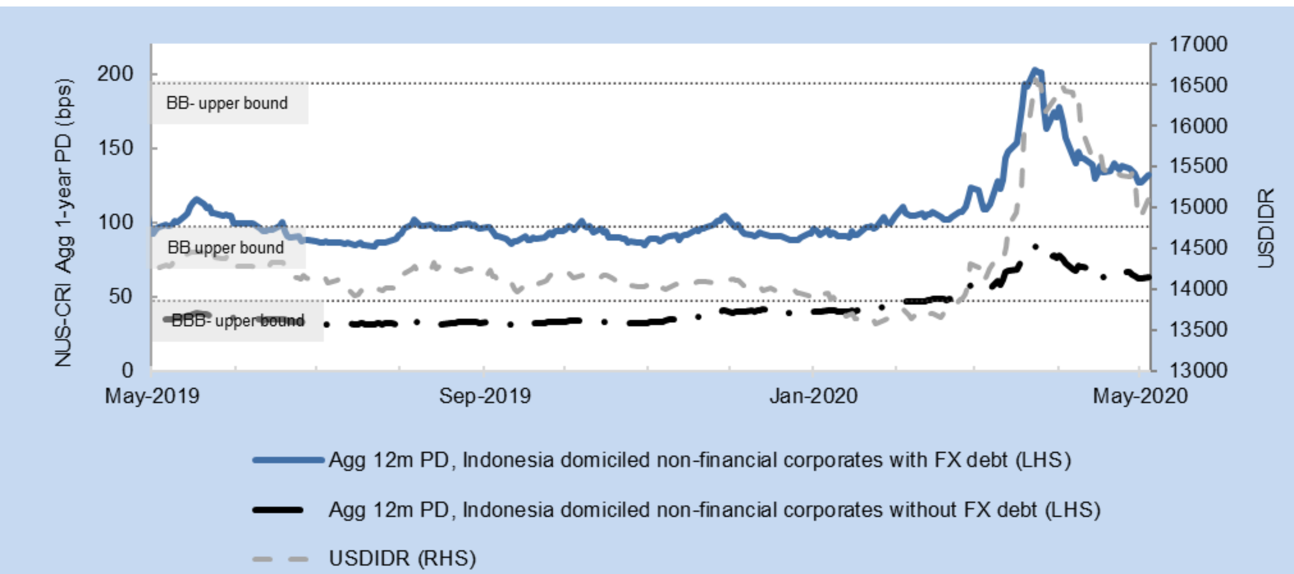

Figure 1: NUS-CRI Agg 1-year PDs for Indonesia domiciled non-financial corporates with FX debt and Indonesia domiciled non-financial corporates without FX debt bounded by PDiR[2] (LHS); USDIDR(RHS). *Source: NUS-CRI, Bloomberg*

In general, Indonesia domiciled non-financial corporates with foreign-currency denominated debt have had a higher credit risk compared to the other non-financial corporates due to the relatively volatile domestic currency[3] and being more exposed to the international financial markets conditions. During the COVID-19 pandemic, however, there are two more direct implications on the weakening of IDR for corporates relying on foreign denominated debt. Firstly, they will face an increase in interest payments as the drop in IDR value would make any debt in foreign denominated currency costlier to pay. This, in turn, could raise the corporates' debt risk profile

[1] USD denominated debt comprises more than 90% of the publicly-listed Indonesia domiciled non-financial corporates foreign currency debt covered in this article.
[2] The NUS-CRI Probability of Default Implied Rating (PDiR) provides a more conventional interpretation of PDs – it translates NUS-CRI 1-year PDs to letter ratings by taking reference from the historically observed default rates of S&P's rating categories.
[3] Indonesia is widely known to be part of the fragile five countries

and thus increase their PDs. Several debtors have already begun asking for deferral in interest payments, highlighting the severity of the impact the pandemic has on those corporates.

The second factor concerns with the corporates' ability to refinance their debts, particularly those with debts maturing within the next 1-2 years. It is estimated that corporates with foreign denominated debt will see around USD 10bn of their debt maturing during that period. Worryingly, investors' sentiment will likely remain weak in the short term as the current extent of the economic damage caused by the pandemic is still unclear. Combined with the currency depreciation, corporates that typically rely on foreign denominated debt could face complications in refinancing their debt as investors will likely remain risk averse in the short-term (particularly towards high-risk borrowers). The NUS-CRI Aggregate (mean) Forward 1-year Probability of Default (Forward PD[4]) in figure 2b below also suggested that the deterioration in credit outlook will be more pronounced in the short term. However, if the corporates could survive until next year, the Forward PD will eventually decline, suggesting that the markets will more optimistic in the long-run.

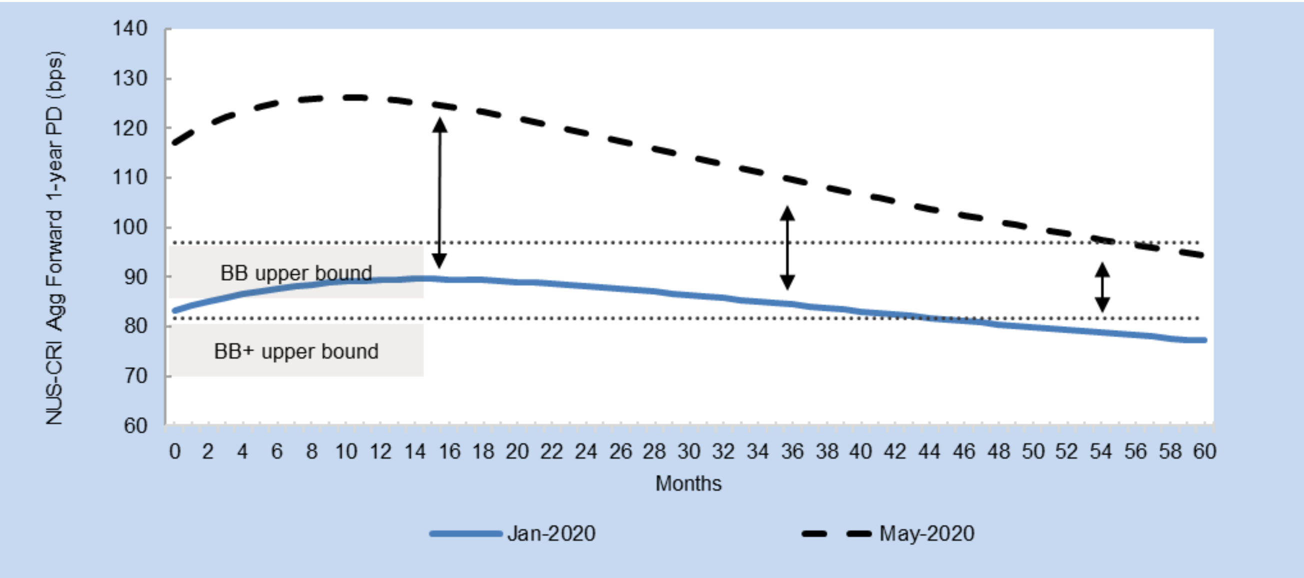

Figure 2: NUS-CRI Agg Forward 1-year PD for Indonesia domiciled corporates with foreign denominated debt in Jan 2020 and in May 2020 bounded by PDiR. *Source: NUS-CRI*

So far, corporates with foreign denominated debts suffering the worst deterioration in credit quality are those working on the commodities and real estate sector (see Figure 3a). Corporates within the commodities sector are vulnerable during this crisis as they are experiencing increased risks from lower commodity prices, which were partially caused by faltering demand as a result of the social restrictions imposed by governments to curb the virus spread. As people are restricted in travelling both domestically and internationally, demand for energy commodities such as biodiesel naturally plunged, thereby detrimentally affecting Indonesian crude palm oil corporates. The hit also came from the manufacturing sector, many of which were forced to cut production due to weak demand and therefore further lowering demand for industrial commodities such as metals and coals. Coal miners, which make up a bulk of the Indonesian commodities sector with foreign debts, are also facing increasing scrutiny from creditors that are increasingly concerned over environmental risks caused by mining activities and could, therefore, limit the source of capital for coal miners.

[4] 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.

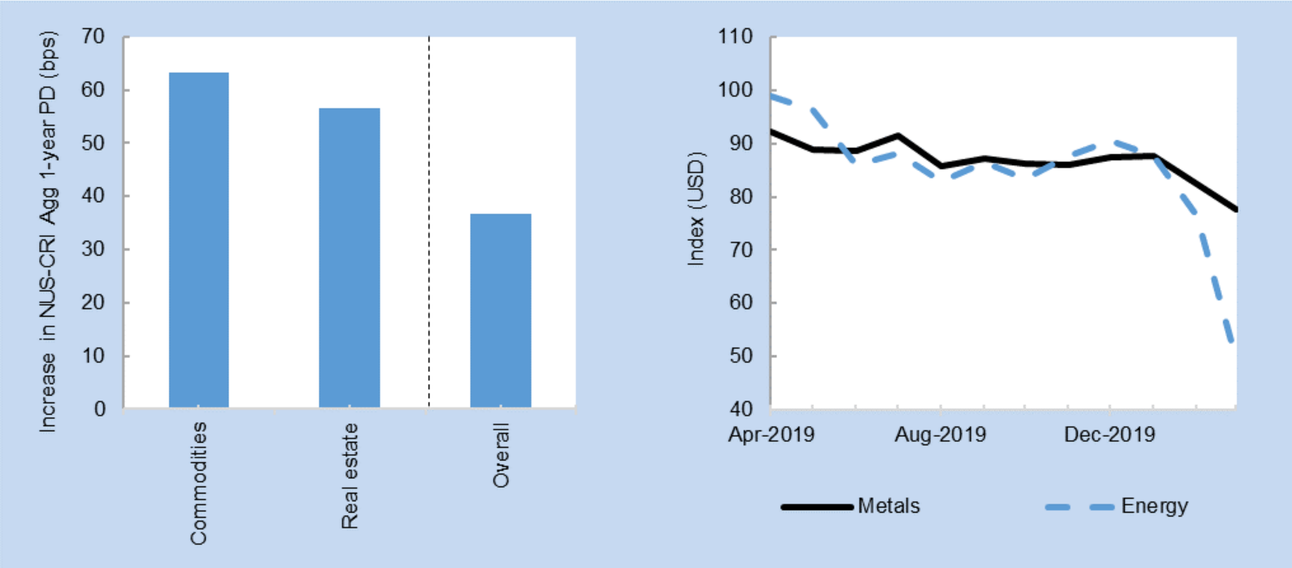

Figure 3a (LHS): Increase in NUS-CRI Agg 1-year PD from Jan 2020 to May 2020 for Indonesia domiciled non-financial corporates with foreign denominated debts. Figure 3b (RHS): Commodity price index. *Source: NUS-CRI, World Bank*

Meanwhile, real estate corporates are particularly affected since they receive the majority of their income in IDR while borrowing in foreign currency. For the past few years, challenging market conditions have resulted in them having higher leverage and weak cash flows. As the economy continues to stagnate, people will put on hold buying new properties which in turn, will affect the ability of those corporates to generate income. Sales of apartments in Indonesia has already been forecasted to decline by around 25-30% in this quarter compared to the average sales of the final two quarters in 2019. The situation is exacerbated by needing to make interest payments in a foreign denominated currency, which will be costlier when their local currency depreciated.

Eventually though, the ultimate impact of the current pandemic on the corporates credit profile is still far from certain and will depend on how long the current pandemic will persist. For now, the Indonesian government has rolled out fiscal stimulus such as giving corporates tax breaks and deferring import tax payments for 6 months. In a bid to stabilize IDR, Bank Indonesia has also increased the volume of its intervention in the financial markets. Despite all of the measures taken, some analysts believe that economic recovery in Indonesia will take much longer than others in South East Asia due to the government's relatively late containment efforts. As such, it seems unlikely that the capital markets will normalize in the short-run, necessitating corporates to diversify their funding sources or risking an increasing likelihood of default.

Credit News

Treasury market sends bearish signals as stocks rise

May 8. US bond markets sent bearish signals in stark contrast with rising equity prices. While the US benchmark S&P 500 index rose 1.2%, the yields on two- and five-year Treasuries fell to their lowest levels ever. Yields fall as bond prices rise. Fed funds futures investors priced in the possibility of negative rates between minus 0.015% and minus 0.03% for late 2020 and early 2021, despite that the Fed chair comments that a negative interest rate policy was not appropriate in the US. However, hedges are still needed even if the chance of the central bank to pursue a negative interest rate policy is slim. (FT)

Distress funds eye more direct loans to Chinese companies

May 7. Distressed debt investors and fund houses have been looking to fund cash-tight companies that have the potential to emerge stronger post-pandemic. This pandemic has posed an opportunity for the fund managers to snap up some of China's USD 1.5tn bad debt. The high demand for funding has also boosted the yield for investors from 12% to 18% at the end of 2019. The short time frame required to carve out direct loan deals made it much more ideal compared to buying up portfolios of bad debt. However, one caveat is that direct lending transactions are to a single borrower and so it carries greater concentration risk compared to a distressed loan portfolio. This window of opportunity for distressed funds to provide high-yielding direct loans to struggling companies also has to be grasped quickly before the day when liquidity is flushed and shadow banking clampdowns are eased. (Asian Nikkei Review)

ECB offers to pay banks to keep credit flowing, but lenders say 'No'

May 7. The European Central Bank (ECB) has offered to pay eurozone banks if they keep loans flowing to eurozone businesses, but many banks have turned the central bank down as the banking sector in eurozone has long been weak, fragmented and burdened with problems debts from its last crises. ECB officials are currently hoping for a strong take-up at the next long-term loan operation in June but some analysts are less optimistic about it. They think ECB's tools are limited in the current phase since cheap liquidity does not insure against credit risk, and applying for the ECB's loans is tricky, especially for the region's smaller lenders who must provide copious detail on recent lending volumes. (WSJ)

Banks' debt burden lightened by rally in leveraged loan market

May 7. Due to the rebound in the leveraged loan market, the situation of European banks with high-risk debt that they were unable to sell improved. Especially banks which agreed to provide debt for M&A deals before the pandemics strike suffered. But the recently rising markets and hedges against their exposure might reduce the pressure to sell their debt to third-party investors. However, banks acknowledge that the continuing market volatility indicates that the problematic phase is not over yet. Some of the companies they are exposed to have been downgraded due to the virus. Therefore, banks consider to shift unsold deals, but then they run the risk of increasing volatility or a deterioration of their credit quality. (Bloomberg)

Non-bank lenders raise concerns over access to 'bounce back' loans

May 6. Non-bank lenders fear that the newly implemented 'bounce back' loan scheme will destroy competition in the market for loans to small businesses. These bounce back loans allow small companies to apply for loans of up to GBP 50,000 under a scheme implemented to help businesses cope with the pandemic. Loans of up to 25% of their revenue will available for up to six years at a 2.5% fixed rate. As non-bank lenders are unable to offer loans at such low rates as their primary source of funding is from capital markets which have been in a standstill since the onset of the virus, lenders currently involved in the bounce bank loan scheme are mainly major banks which prioritize their existing customers. This forces small businesses to move their primary banking relationship from non-bank lenders to big banks just to get funding which, in the long run, could be detrimental to the loan market because of the forgone competition. (FT)

Indonesia drafts USD 1bn rescue package for flag carrier (Bloomberg)

Private-equity backed companies dominate lowest depths of junk (FT)

Moody's slashes green bond sales forecast after poor quarter (Bloomberg)

Regulatory Updates

ASEAN banks prepare for flood of bad loans amid coronavirus havoc

May 8. ASEAN banks are bracing for a tide of nonperforming loans as the coronavirus pandemic rattles companies' cash flows and creates difficulties in repaying debt. Singapore-based OCBC on Friday said its net profit for the first quarter ended March tumbled 43% year-on-year to USD 495mn, as it increased total allowance by 165% due to oil and gas exposure and worsening economic conditions. Credit rating agencies in April began downgrading the credit outlook for banks, and the International Monetary Fund projected that the five largest developing economies in the region will contract by 0.6% in 2020. Though aggressive stimulus measures from ASEAN governments should provide some relief for banks facing mounting risks, asset quality, falling rates and recession fears remain dominant concerns. (Nikkei Asian Review)

China pledges stronger monetary policy to soften growth hit

May 10. Chinese central bank said it will resort to more powerful policies to deal with the challenges from the COVID-19 pandemic, paying more attention to economic growth while balancing multiple policy targets. It reiterated that prudent monetary policy will be more flexible and appropriate, and it will keep liquidity at a reasonable level. While the central bank has increased liquidity supply to banks and eased rules on banks' buffers to allow them to extend more credit, the scale of the stimulus is limited compared to other major economies globally. (Bloomberg)

China regulator seeks to tighten rules on banks' online lending (Bloomberg)

Fed's balance sheet expands again, grows to USD 6.72tn (Bloomberg)

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Contributing Editor: Yao Xuan, Luo Weixiao