Credit Research Initiative
Risk Management Institute, National University of Singapore
NUS National University of Singapore | RMI Advancing Risk Management for Singapore and Beyond
transforming big data into smart data
Weekly Credit Brief May 19 - May 25 2020

Brazilian companies' credit risk jumps as Covid triggers a 'perfect storm' to end 4-years of steady improvement

by Mehul Sukkawala

In January this year, we published a report on Brazil highlighting the consistent improvement in its credit risk after the low point of early 2016. But all of this has changed in a matter of months. The Covid-19 pandemic which started in Asia, moved to Europe and the US, has now taken hold of Latin America and in this Brazil is the epicentre. The country now has the 2nd highest number of confirmed Covid cases in the world and 6th highest number of deaths. This has exposed the Brazilian companies to significant risk. They face lower demand due to partial lockdowns in the country, weaker global economy due to Covid, economic slowdown in China (a key trade partner) and lower commodity prices. In addition, they are also exposed to political uncertainty which together with other factors has resulted in a challenging financing environment for companies. This could result in higher defaults this year as was experienced in 2015-2016.

The credit profiles of publicly-listed Brazil domiciled firms, tracked by the NUS-CRI 1-year Aggregate (median) Probability of Default (Agg PD), jumped in March and further increased before starting to moderate in May to 52 bps. The Agg PD peaked at 85 bps which was even higher than the peak registered during 2015-2016 recession in early 2016 of about 68 bps. Nevertheless, the jump in Agg PD for Brazil (the largest economy in LatAm and Caribbean region) is significantly more than the overall region as well as Mexico which is the 2nd biggest economy in the region.

The weakening in credit profile has also translated into about 60% of the listed companies being rated as non-investment grade in comparison to only about 25% a few months back according to the NUS-CRI Probability of Default Implied Ratings (PDiR[1]). This has meant the reversal back to the late-2015 levels. During this current crisis, Brazil's utilities and financial sector are the only two sectors with sizable number of companies that are currently investment grade as per PDiR. The utility sector's strength reflects the above average financial flexibility to raise debt and past track record of support from the government. In the case of the financial sector, we believe it reflects their strong regulatory capital ratio, liquidity ratio and low delinquency levels.

[1] 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.

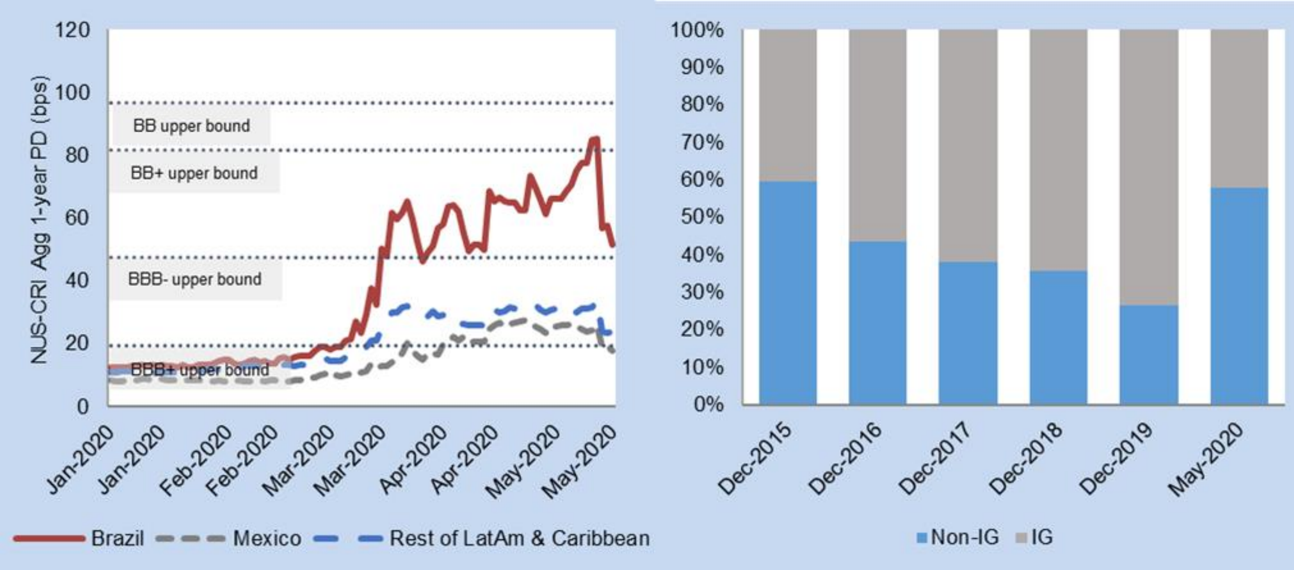

Figure 1a (LHS): NUS-CRI Aggregate 1-year PD for listed companies in Brazil, Mexico and rest of LatAm and Caribbean countries for 2020 bounded by PDiR; Figure 2b (RHS): Proportion of investment and non-investment grade listed companies in Brazil according to PDiR. *Source: NUS-CRI.*

Brazilian companies are facing pressure on their credit quality due to weaker demand. This is on account of the stay-at-home order by many of the local and regional governments even though the central government led by President Jair Bolsonaro has opposed these measures. The stay-at-home order has put pressure on airlines, hotels, auto manufacturers, retailers as well as power distribution companies. The weaker demand is evident from the contraction (PMI of less than 50) over the last 2 months in IHS Markit's Brazil PMI data in Figure 2a. In fact, the government has revised its GDP growth forecast to 4.7% contraction for 2020. This would be the biggest annual fall since records began in 1900 and is despite the government's fiscal support package.

Brazil's commodity companies are also facing pressure with lower commodity prices, as can be seen by the S&P GSCI index in Figure 2b, driven by weak global economic conditions as well as China's slower economic growth. The adverse impact on commodity companies is partly offset by about 30% fall in Brazilian real against US dollar as commodities are mostly exported and are generally traded in US dollar. But still the energy and basic materials sector are the worst performing sectors in the country with Agg PD of about 100 bps translating to 'BB' rating level.

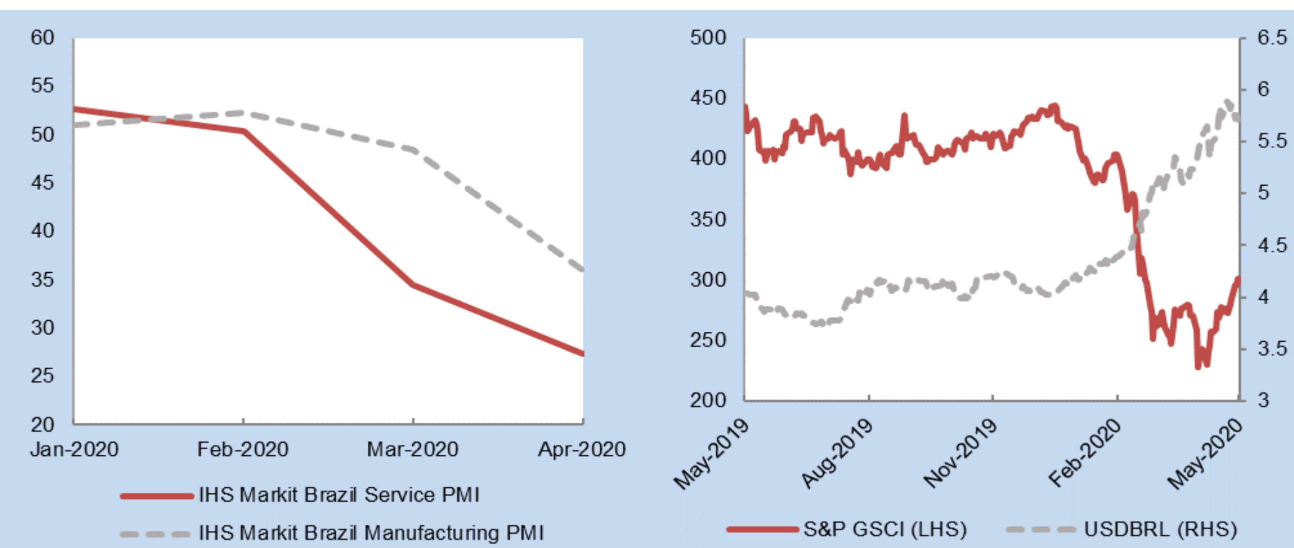

Figure 2a (LHS): IHS Markit's Brazil Purchasing Managers' Index for Service and Manufacturing; Figure 2b (RHS): Commodity and currency trend. *Source: IHS Markit, Bloomberg, NUS-CRI.*

Brazil has also been hit by political uncertainty which has added to the adverse sentiment among investors who were already cashing out of most emerging markets. According to EPFR, the emerging market equity funds it tracked registered 11th straight week of outflows in the last week of April with Brazil facing heavy outflows, biggest since mid-Q3 2013, in Latin America. The political environment worsened in recent weeks by the resignation of an important justice minister, who led the Lava Jato corruption cases, in late April and his accusations of President Bolsonaro's political interference in the federal police. In addition, the President fired the first health minister on April 16th after differences on ways to manage the Covid crisis and, subsequently, the new minister resigned in a month too.

The souring of investor sentiment has adversely affected the fund raising and refinancing plans of Brazil's companies. As we can see from Figure 3a, bond issuances by companies are significantly lower so far this year. This is because the spreads in the international as well as the domestic market have significantly widened. In the domestic market, according to JGP Asset Management, Brazil registered about BRL 11bn of withdrawals from credit funds in February and March this year. This is estimated to account for about 12% of the independent credit-fund industry's total outstanding assets. Furthermore, this also places companies under liquidity stress to bridge the weak cash flows as well as refinance about BRL10-15bn maturing this year and next. They are therefore looking to government and banks for support. The banks have stepped into the vacuum by buying bonds from the secondary market and new issuances directly from the company as well as by providing syndicated loans. In addition, banks are also in discussion with the central bank and the government development bank BNDES on ways to rescue embattled companies. Lastly, the central bank has also been given extraordinary power to buy private and public sector bonds by the government through a constitutional amendment.

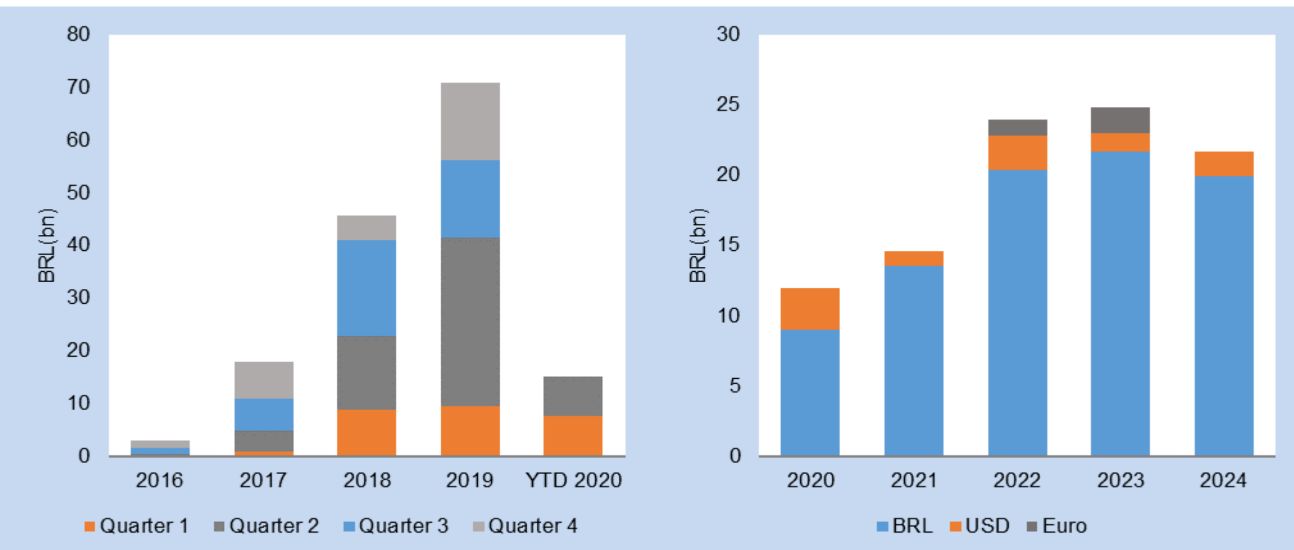

Figure 3a (LHS): Quarterly bond issuance by Brazilian companies; Figure 3b (RHS): Bond maturity schedule for Brazilian companies. *Source: Bloomberg, NUS-CRI.*

Even though the Agg PD for Brazilian companies improved in May, the CRI data shows that there is still further risk on the horizon. We believe the risks could potentially persist for the next 1 year before registering a gradual improvement. This is as per the NUS-CRI Aggregate (median) Forward 1-year Probability of Default as show in Figure 4a. It potentially reflects the increasing rate of Covid infections in Brazil as well as the political uncertainty. The trend for Brazil is better than its regional peer Mexico as well as the rest of the LatAm and Caribbean region where we see a further weakening from a low base. Nevertheless, the high Agg PD and Forward 1-year PD could be a forebearer of default risk similar to what we had seen in 2015-2016 when S&P Global Ratings recorded default by 18 companies (see Figure 4b) as compared to only 3 in the prior 2 years. At the same time, the defaults could be reigned in if the confidence in the economic stability and growth returns like in 2017 which will benefit the corporate sector. This will require return to political stability enabling the government to bring back the economic reforms as well as controlling the Covid spread to allow the economy to reopen quickly.

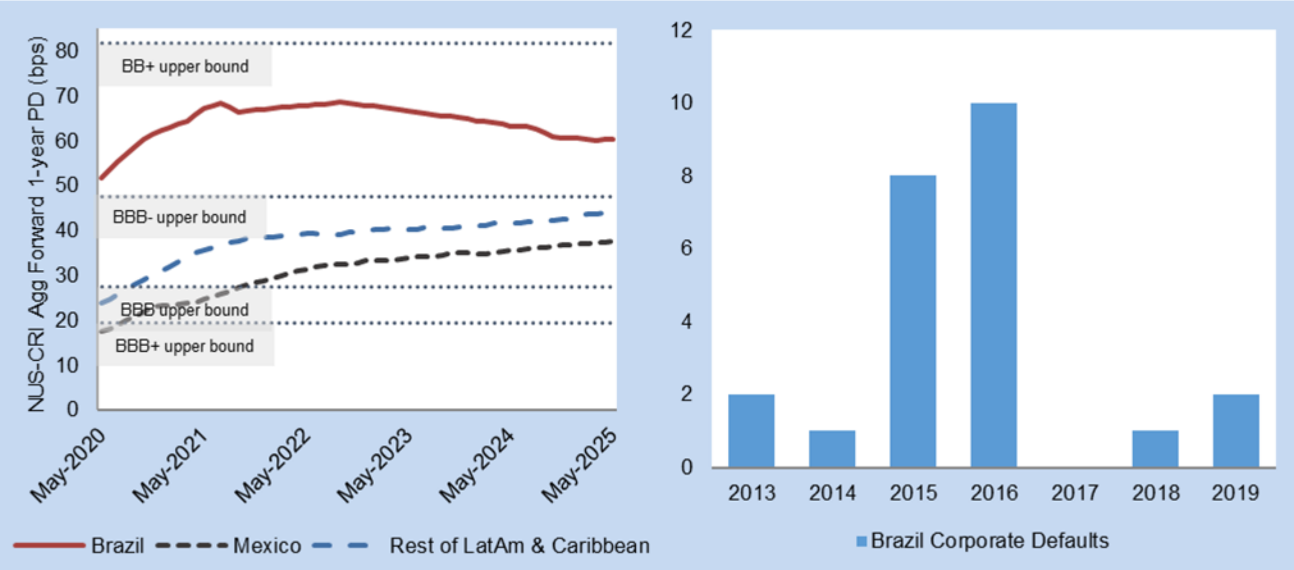

Figure 4a (LHS): NUS-CRI Aggregate Forward 1-year PD of Brazil, Mexico and rest of LatAm and Caribbean region as of May 2020 bounded by PDiR; Figure 4b (RHS): Corporate defaults in Brazil. *Source: NUS-CRI, S&P Global Ratings*

Credit News

Asia's rich brush aside risk to buy Chinese developer debt

May 25. Wealthy investors from Hong Kong and mainland China are important buyers of Chinese developers' USD bonds. As Chinese developers sold USD 26bn in bonds in this year's first quarter, much interest came from these investors. Increased interest from family offices and private bank clients is an important support since developers plan to refinance or repay about USD 20bn of debt while having uncertain real estate prospects. Lockdowns in Asia's largest economies led to over 100 builders going bankrupt and increasing numbers of unemployed. By now, debt issued by developers makes up for most of China's junk bond issuance. However, there is confidence that China won't allow a property collapse amid a period of slowing economic growth. (Bloomberg)

Companies ditch commercial paper to lock in long-term debt

May 25. Companies which have long relied on the commercial paper market to raise cash, are paying off tens of billions of dollars of borrowing in favor of new longer facilities after fears over COVID-19 took hold. In total, over 40 companies have raised a combined USD 97bn in debt this year in part to refinance commercial papers, which marks a record high and comes close to surpassing the USD 105bn borrowed in all of 2008 and 2009 during the previous financial crisis. In turn, commercial papers issued by firms outside the financial industry has dropped to its lowest level since 2016. (FT)

Corporate bond rally picks up momentum

May 22. US corporate bonds wrapped up another strong week on Friday, showing investors' hope for an economic rebound and support from the Fed. The average spread on both speculative-grade and investment-grade bonds were down the most since the week ended April 17. The yield of 10-year Treasury note settled at 0.659%, compared with 0.677% on Thursday. Various market gauges on Friday suggested relatively little change to those levels. Actions taken by the Fed have played a crucial rule in lifting corporate bonds. Inspired by the Fed, individual investors also have been pouring money into bond funds. (WSJ)

Court case threatens to shake up USD 100bn in Chinese dollar bonds

May 20. Administrators in the restructuring of Peking University Founder Group, a powerful state conglomerate, have denied to recognize USD 1.7bn keepwell deeds that back its debt. Keepwell deeds are letters of support that do not require regulatory approval introduced to give foreign investors assurance in China's dollar bond market. If the Beijing court rules in favor of the administrators it could trigger a re-pricing of almost USD 100bn of Chinese dollar bonds backed by the deeds. This will cause keepwell bond yields to rise, forcing many issuers of these bonds to restructure their debts to incorporate a direct guarantee since the keepwell structure has been ruled invalid by the court. Credit ratings on these bonds and issuers will also have to be adjusted if the court ruling nullifies keepwell deeds. (FT)

Bond investors balk at use of 'ebitdac' to skirt debt restrictions

May 19. In the first quarter of 2020, some companies began to report 'ebitdac' – earnings before interest, tax, amortization and coronavirus. These measures may enable companies to paint a rosier picture of their current state as well as using it to raise additional debt. Debt deals often include covenants, which aim at protecting investors by imposing restrictions that prevent businesses from taking on debt they cannot pay back. With the new metric, companies are able to assume the profits they believe they would have made under the assumption of the absence of the coronavirus to make debt contracts. However, there is a danger of loose definitions becoming the norm as they allow companies to relax covenant terms for any unfavorable event. (FT)

Hertz files for US bankruptcy protection as car rentals evaporate in pandemic (Reuters)

US leveraged loan defaults at six-year high as coronavirus hits businesses (Reuters)

Creditors of Brazil's Odebrecht ethanol unit approve restructuring plan (Reuters)

Regulatory Updates

Bank of Japan to create its version of Fed's 'Main Street' lending scheme

May 22. Japan's central bank will create its version of the US Federal Reserve's "Main Street" lending program to channel more money to small businesses. The program is intended to keep the coronavirus pandemic from pushing the economy deeper into recession. According to an outline of the scheme released in April, the Bank of Japan (BOJ) would pump cash to commercial banks that lend to small firms using funding-aid program launched by the government. Furthermore, it would also pay 0.1% to banks that boost such lending. (Reuters)

Bank Indonesia to provide liquidity for banks involved in loan restructuring

May 22. Bank Indonesia will help provide liquidity for local banks involved in a credit restructuring program for micro, small and medium enterprises as part of its efforts to support the country's economic recovery. Banks could use sovereign debt papers they held as underlying assets for repo with the central bank to get fresh funds. Indonesian banks owned IDR 886tn in government bonds and could transact IDR 563tn worth with the central bank should they need liquidity. BI has also lowered the reserve requirement ratio for banks that provide loans to export-import companies, small and medium business and other prioritized sectors to provide more liquidity. (Jakarta Post)

Turkish central bank trims rates, says worst might be over (Reuters)

South African central bank cuts lending rate by 50 basis points (Reuters)

Published weekly by Credit Research Initiative – NUS Risk Management Institute | Disclaimer
Contributing editor: Anthony Prayugo, Zhu Yanqi