The Australian Coal Industry faces a worsening credit outlook with heightened financing risks

by Vivane Raj

- **The credit outlook for Australia domiciled corporates in the coal mining sector may deteriorate amidst global decarbonization trends as demonstrated by the NUS-CRI Forward PD**
- **The transition away from coal power may be a significant headwind for the sector, as corporates face tightened access to funding**

In 2019 we covered the credit health of coal producers in Australia, which benefited from strong demand and political support. However, the sector has faced significant challenges as of late. Shockwaves rippled in Oct 2020 as China, the country's biggest importer of coal, unofficially banned Australian coal from its shores. The import ban, which stemmed from pandemic-induced political tensions, led to the fall of imports of Australian coal to nearly zero in Jan 2020. Additionally, major financial institutions began to move away from funding coal projects due to ESG concerns. This may lead to a deterioration in credit quality for Australian coal producers, as demonstrated by the NUS-CRI Aggregate (Median) Forward 1-year Probability of Default (Forward PD[1]) (see Figure 1). Overall, the Forward PD for Australian coal producers crosses above the level for all globally listed coal producers over the short term, possibly indicative of a weakening credit outlook for the nation's coal miners in the years to come.

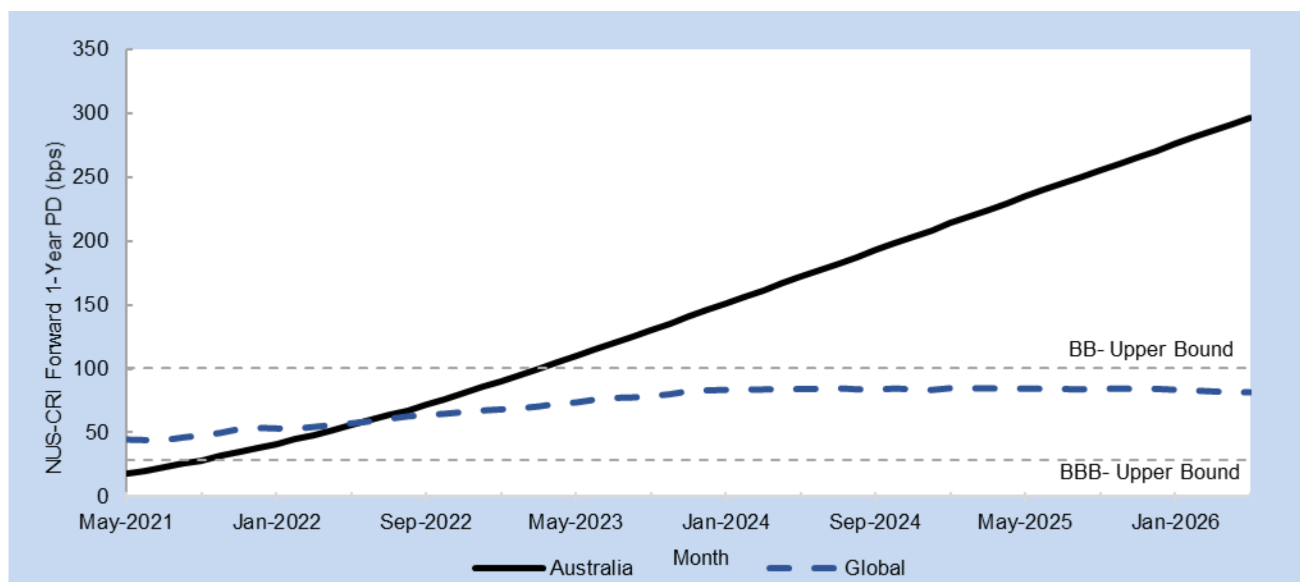

Figure 1: NUS-CRI Agg Forward PD for listed Australian and global corporates in the coal mining sector as of May 2021 with reference to PDiR2.0[2] bounds. *Source: NUS-CRI*

[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 18 months, conditional on the firm's survival in the next 6 months.

[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.

Australian coal producers face long-term structural headwinds as decarbonization policies are pushed into the forefront of discussion. The four biggest banks in Australia[3], have made strategic decisions to taper lending to coal firms. ANZ in particular has stated that it would not on-board new clients that obtained more than 10% of its revenue from thermal coal, while all banks have made plans to shut off all funding access to coal producers by 2030. As stakeholders in these financial institutions focus on meeting global ESG standards to move towards net-zero emissions, support for coal producers is likely to wane going forward. Producers have now begun to rely on Asian banks to provide financing as domestic institutions shy away. However, this may be insufficient in the long run as well, given that international lenders are likely to only support companies that are also backed by local banks.

In addition, insurance firms have also slowly pulled back services to the coal sector. This may increase refinancing risk as companies and debt holders would have to bear increased risks for new projects, which could elevate borrowing costs moving forward. The revocation of public liability insurance as well environmental protection insurance may put a strain on coal producers as well, as land rehabilitation payments would now likely be borne directly from operational cash flows, adding additional strain on liquidity buffers. These issues may compromise the financial health of Australian coal producers, especially given their weakening liquidity positions, as the median current ratio of the sector fell from 1.97 in H1 2020 to 1.16 in H2 2020.

However, the reduction in financing opportunities has not deterred the operational expansion plans of the sector, with coal mining lobbyists demonstrating strong political support against decarbonization measures such as early closure of mines and strict emissions standards. This may close financing routes such as green bonds, which could be utilized by the sector for decarbonization efforts or plant decommissioning. Overall, a potential complete shutoff in the sector's financing may contribute to a worsened credit outlook as corporates scramble to repay or refinance their current obligations with dwindling liquidity reserves. These issues are likely to be faced by most of the companies in the sector, as demonstrated by Figure 2a. The Forward PD indicates that over a third of the listed Australian coal producers will experience an increase in PD above 90bps over the next 24 months, which is indicative of a deteriorating credit outlook going forward.

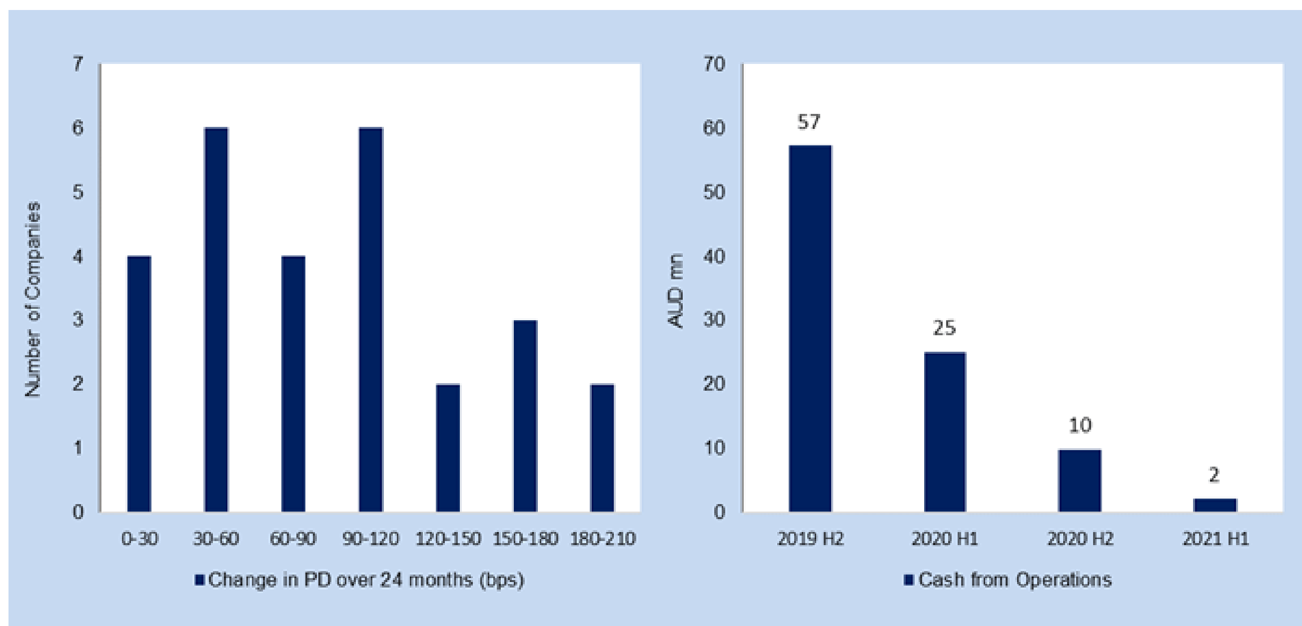

Figure 2a (LHS): Change in PD for listed Australian coal producers over the next 24 months as indicated by Forward PD. Figure 2b (RHS): Average cash from operations for Australian coal producers across fiscal semi-annual periods in 2019, 2020 and 2021. *Source: NUS-CRI, Bloomberg*

China's disruption of its coal supply chains resulted in a blowback in the overall demand for Australian coal. The total exports of Australian thermal coal fell by 25.8% to 13.5mn tonnes in Mar 2021 as compared to the same time last year, resulting in the lowest total exports from the country in 8 years. While trade tensions between

[3] The Commonwealth Bank of Australia, Westpac Banking Corporation, ANZ Banking Group and the National Bank of Australia

Australia and China could mend, China's long-term decarbonization trends are likely to affect Australian coal producers' outlook in the long term. Furthermore, Australia's biggest export destinations for thermal coal, Japan, China, and South Korea, are projected to reduce their overall imports by 2026 as the countries pledge to decarbonize their economies in the long term. As a result, Australian coal producers have been forced to improvise. Trade flows for coal have slightly improved in the short term, largely attributed to a 13% MoM increase in exports to India in Apr 2021. While this may be positive for Australian coal producers in the short term as they stand to benefit from a rebound in Indian energy demand when the lockdown measures ease, it is not sustainable in the long-term as India is also planning to reduce the proportion of coal in its energy mix. In 2020, the power minister of India proposed increasing its renewable energy generation capacity to 450GW by 2030. This may mean that coal power usage may have already peaked in India, especially if the country's renewable energy goals are met on time.

As demand for coal dwindles, nominal prices of thermal coal are expected to reduce to around USD 60 per tonne by 2026, marginally above 2020 levels. This may negatively impact producers looking forward, as tightening margins, similar to that in 2020, are unable to cover production costs. If prices were to stay at those levels operating cash flows may remain muted affecting the industry's liquidity position (see Figure 2b). As for metallurgical coal, nominal prices are expected to recover from USD 125 per tonne in 2020 to USD 166 per tonne in 2026. However, the long-term value of export earnings from metallurgical coal will unlikely recover to levels seen before the pandemic in 2018 and 2019.

While financial institutions continue to put pressure on coal producers, the sector continues to enjoy support from policymakers. Australia's resource minister has suggested that pension funds should be used for coal project financing as institutional investors slowly pull back away from supporting fossil fuel projects. In addition, tax breaks and subsidies amounting to AUD 10.3bn were given out to the fossil fuel industry in 2020, amidst a sharp jump in applications for new mines to be opened. However, the environmental impacts of the coal sector are still difficult to ignore. There has been pushback against future coal production expansion, with strong public support for moratoriums against the opening of new mines. Overall, the pressure placed on Australian coal producers to adapt to environmental policies may prove to lead to the deterioration of their credit quality in the long term.

Credit News

China lures foreign debt buyers despite corporate default fears

May 28. Global investors are warming to Chinese bonds and are looking at safer alternatives beyond sovereign debt. Bonds issued by Chinese "policy banks" have attracted attention since they are state-owned and offer a quasi-sovereign low level of risk while still offering higher yields than sovereign debt. As China opens up and gets included in more global bond indices, foreign investors are expected to increase their ownership in China's bond market despite the spate of defaults by state-owned companies since late last year. Furthermore, investors resumed net purchase of Chinese bonds after a surprise drop in Mar as the spreads between Chinese bonds and the US Treasuries widened by 19bps in Apr. At the end of Apr, foreign holdings of Chinese government bonds rose 2.5% to a record CNY 2.096tn, which has doubled in the past two years. (Nikkei Asia)

Global CLO market approaches USD 1tn milestone as sales soar

May 28. The CLO market shows little sign of slowing down despite concerns earlier in the year with the amount of outstanding bonds reaching USD 1tn. CLO markets hold steadfastly in most rating tiers, surprising investors that were worried about their health, even if the Federal Reserve intervened. Forecasts of USD 360bn of US CLO sales this year alone could increase the already inflated USD 700bn of outstanding USD CLOs. This change is driven by larger institutional demand for fixed-income portfolios, especially with large US banks re-entering the CLO market. Another factor influencing demand includes the demand for floating-rate debt, as investors continue speculation on increasing policy rates. However, risks of rising inflation and too much government stimulus may impact the market, especially if ‘zombie companies’ default on their obligations, thus affecting the lower-rated spectrum of CLO assets. (Bloomberg)

Debt-fueled property boom drives record Nordic euro-bond sales

May 28. The Nordic non-financial and real-estate firms are selling record-high euro bonds despite bond issuance slowing down in other European countries. These Nordic companies are estimated to issue as much as EUR 40bn of bonds in 2021, with the real-estate debt acting as the main contributor to issuances. From January to May 2021, Nordic issuers have sold EUR 19bn bonds, experiencing a 33% increase compared to the same period last year. Furthermore, much of the bonds issued have been tied to rising ESG demand in the region. However, with bond prices being more accurately priced, investors are left with no room for error as spreads tighten and policy rates increase. (Bloomberg)

Convertible debt sold by high-flying US groups falls back to Earth

May 27. Investors have been hit by the fall of convertible bond prices as fears of higher inflation have pushed interest rates up and dragged the debt’s value down. When sentiment was strong earlier this year, several companies sold their bonds with a zero-coupon and a high strike price, meaning they do not have to pay interest and the potential of shares dilution is low. Rising inflation fears amid the economic recovery, however, have triggered an exodus from convertible bond funds, with a net outflow of USD 530mn in the week next to May 12. Consequently, the yields on the converts are higher and push some stock prices down. The stock price decline would again make the convertible bond moves further out of the money, making it less attractive. (FT)

Emerging-market bonds prove Covid resistant

May 25. Bond yields in emerging economies have remained stable despite new waves of infections and record-high COVID-19 cases. India’s 10-year yield has been stable at 6%, whereas yields on an index of Argentina’s foreign currency bonds declined to 13.7%. The inability of poorer economies to implement strict lockdowns due to macroeconomic costs has caused investors to be willing to hold on to the relatively high-

yielding debt, even as cases continue to increase. With developed market yields at historic lows, emerging market debt is increasingly attractive to investors. Risks attached to increasing infections are perceived to be low due to a global commitment to vaccinate 40% of the world population by Dec 2021. However, the possible withdrawal of pandemic stimulus efforts by the Federal Reserve, and political fallout pertaining to high public spending, pose a risk moving forward. (WSJ)

Huarong wires USD 978mn for maturing bonds as doubt persists (Bloomberg)

US corporate bond spreads hit 14-year low as economic resurges (Bloomberg)

India bond returns are the best in Asia as Covid cases drop (Bloomberg)

Regulatory Updates

Central banks signaling policy shifts

May 28. Central banks around the world are reversing their monetary policy stances as vaccine rollouts continue and economies reopen. Investors around the world are pricing in a slow-down of bond purchases and a potential increase in interest rates as major central banks, such as BoE, have given an early indication of faster than expected recovery. However, not all central banks have indicated a reversal in policy. For example, the ECB has not seen a shift in the economic outlook that justifies a reduction in its bond purchase programs. These concerns would make central banks in the Eurozone and emerging markets delay policy shifts, as slow vaccination process and further COVID-19 infections continue in these regions. (Business Times)

Fed reverses repo volume hits record high

May 28. The Fed's reverse repurchase (RRP) facility saw a record-high inflow of USD 485bn, further pushing down key short-term interest rates that may go below zero. Since Mar, cash-heavy financial institutions have been loaning a growing amount of money to the Fed overnight at 0% rate. The funding market has a glut of liquidity mainly due to Fed and U.S. Treasury's supportive policies in response to the pandemic as well as the Treasury pushing back its balance at the Treasury General Account, before the debt ceiling take effect in Jul 2021. The recent RRP of Fed increases the possibility that it may make additional changes to the counterparty limits on the RRP or may increase the RRP rate. It may also hike interest on excess reserves (IOER), which is currently at 0.1%. (Reuters)

China allows some banks more overseas borrowing to lift loan pressure (Reuters)

Taiwan boosts loans for SMEs, considers further support for economy (Reuters)

Published weekly by Credit Research Initiative – NUS | Disclaimer
Contributing Editors: Emir Hrnjic, Anthony Prayugo, Raghav Mathur