Credit Research Initiative
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Weekly Credit Brief November 25 - December 01

OPEC decision threatens US shale fracking boom

Last Thursday, oil prices declined more than 7% after OPEC (Organization of the Petroleum Exporting Countries) decided to maintain current crude production levels despite months of falling oil prices. NYMEX January West Texas Intermediate Crude dropped from USD 73 per barrel to below USD 65 per barrel on Monday as the oil cartel keeps to its existing 30mn barrels a day production ceiling. OPEC's decision leaves the market with a supply glut that could further weaken the credit profiles of US shale gas producers. The RMI aggregate 1-year probability of default (RMI 1-year PD) for US listed shale gas firms has increased sharply to 21bps on November 28 compared to 3.8bps on September 30.

Saudi Arabia, OPEC's largest crude exporter, is defending its North American market share against cheaper supply from US shale fields. According to the US Energy Information Administration, Saudi exports to the US fell nearly 30 percent from 1.25mn barrels per day in July to below 900,000 barrels per day in August. The country's market share of crude exports to China and India has also decreased and the oil-dependent nation has suggested to other OPEC nations that they should lower prices and undermine the profitability of US and Canadian oil producers.

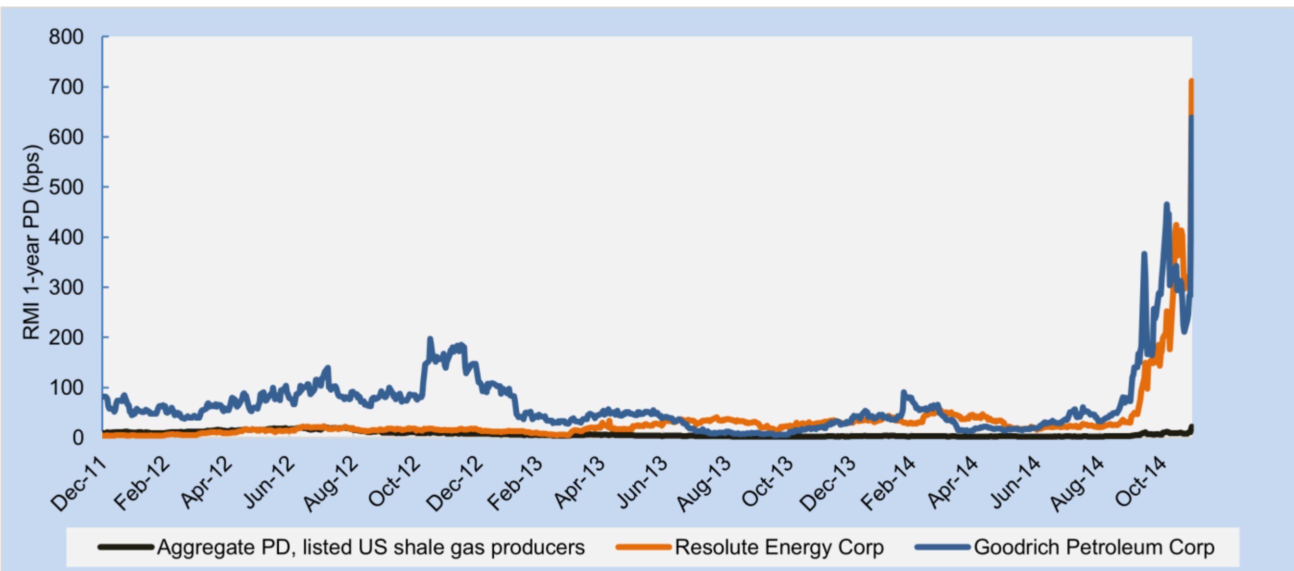

Figure 1: RMI 1-year PDs for US shale gas producers. *Source: Risk Management Institute*

Falling prices of oil has weakened the creditworthiness of the US shale sector. The RMI aggregate 1-year PD remained below 4bps in September but climbed to more than 20bps on the back of lower overall market capitalization as shown in Figure 1. A key input of the PD model - the relative size variable, decreased considerably in October and November, leading to a higher aggregate default risk for the sector. Relative size measures the logarithm of the firm's market value over the economy's median market capitalization. Amongst the list of 59 public companies, Resolute Energy (Resolute) and Goodrich Petroleum (Goodrich) display the highest likelihood of bankruptcy as RMI 1-year PDs for both firms have risen to 711bps and 639bps respectively.

	Average daily production (mn boe/day)			Finding & development cost (USD per boe)			Oil and gas Reserves (mn boe, 3 year average)			Production cost (USD per boe)		
	Industry	Resolute Energy	Goodrich	Industry average	Resolute Energy	Goodrich	Industry average	Resolute Energy	Goodrich	Industry average	Resolute Energy	Goodrich
FY 2011	164.6	8.1	18.5	27.9	13.4	22.0	450.7	71.6	39.2	40.2	33.5	27.9
FY 2012	176.2	9.3	14.3	20.4	31.1	53.2	441.5	26.6	16.4	32.6	54.5	62.3
FY 2013	184.8	12.2	12.7	31.0	88.0	37.0	445.1	14.4	22.9	43.5	111.1	47.3

Table 1: Annual performance metrics for Resolute Energy and Goodrich Petroleum against the industry, measured in units of barrels of oil equivalents. Production costs are derived from lifting and finding costs disclosed by companies in annual reports. Source: *Bloomberg, company reports*

Oil and gas reserves are the most valuable assets as they provide the source of gas production and cash flow to the company. Unlike other sectors, reserves and production are better indicators of the firms' size than certain financial data such as revenue and total assets. Table 1 shows that oil and gas reserves for Goodrich and Resolute have been on the decline since 2011, while industry's reserves have remained flat in the same time period. Reserves and production rates for both companies were also significantly lower than the industry's average, making their small capacities vulnerable to external oil shocks or downturns. Larger firms with bigger reserves possess greater resources, liquidity and inherent economies of scale. In addition, declining production rates creates an uncertain outlook for the consistency and durability of cash flows for Goodrich Petroleum. The firms' ability to control its operating expenses and profitability impact is reflected in finding and development costs (F&D), which is a 3 year average of the capital cost of acquisition, exploration and development of its oil reservoirs. F&D expenses for both companies have risen substantially to exceed the industry's average of USD 31 per barrel of oil equivalent (boe).

Resolute Energy's credit profile is very susceptible for any unhedged exposure or once the derivative contracts expire. In 2015, the firm has hedged exposure to 6600 barrels per day at an average strike price of USD 87 per barrel. As seen from Table 1, Resolute Energy's estimated production cost of USD 111 per barrel in 2013 is higher than the current selling price level (USD 64 per barrel on December 1). However, as of Q3, the firm's derivative positions covered only 60% of the aggregate average daily oil volumes (7700 barrels per day), at an average price of USD 92.02 per barrel. Due to weak market conditions, the firm is exploring alternative financing options to enhance its liquidity position and accelerate activity in the Permian Basin.

Technological innovations have enabled upstream producers to tap into US shale gas fields and raise output from 5bn cubic feet per day (bcf/d) in 2007 to 33bcf/d in 2013. Total US natural gas production from non-shale resources meanwhile fell 25% from 41bcf/d to 31bcf/d during the same period. As long as prices remain above the breakeven oil price of USD 72 per barrel, exploration firms have an incentive to discover more shale gas fields. However, the present market environment has compelled many firms to place their capital expenditures on hold. Firms that are highly geared and possess less diversified business revenue streams could be forced to liquidate core assets as plunging oil prices impact their bottom lines.

Credit News

Co-op Bank says 'no surprise' if it fails stress test

Dec 01. Results of the Bank of England's stress tests on eight banks, including the Co-operative Bank, are estimated to be released on December 16. The Co-op Bank's chief executive has admitted it would come as "no surprise" if the bank fails the stress test, because it has insufficient capital to prepare a severe economic shock. However, the bank's capital position is much stronger than last year after a group of investors injected GBP 1.9bn into the lender. (BBC)

Bank compliance teams turn to IT to spot rogue traders

Dec 01. Banks are using pattern recognition technology to detect rogue traders and cut down regulatory fines and legal fees caused by non-compliant employees. Instead of simply listening to tapes of telephone calls and monitoring electronic communications, the banks and other institutions are analysing different forms of data to identify odd trading behaviours. (Global Legal Post)

Wanda weighs deal for stake in Lions Gate

Dec 01. China's Dalian Wanda Group Co. has been in talks with Lions Gate Entertainment Corp to acquire a stake in the US company. Dalian Wanda Group is keen on purchasing Lions Gate shares from its Chairman Marc Rachesky, who owns 37% of the firm. Wanda has been expanding and currently controls the second-biggest US cinema chain, AMC Entertainment Holdings Inc. Both companies have been in discussion for an investment as the Chinese firm planned to invest USD 1.2bn to set up an office in Beverly Hills. (WSJ)

RUB suffers biggest one-day fall since 1998 as oil slides

Dec 01. Falling oil prices has affected Russia, as 70% of its exports and half of its government revenues consist of oil and gas. Oil prices have fallen by more than a third since the summer, while the RUB has depreciated nearly 40% against the USD since January. OPEC's decision to maintain production levels and a slowing China's economy may have contributed to the falling prices. The economy has also been hit by western sanctions. (BBC)

Moody's downgrades Japan's credit rating

Dec 01. Moody's Investors Service downgraded Japan's credit rating on December 1 on concerns that Japan may not be able to cut its fiscal deficit. Last month, Mr. Abe decided to delay an increase in the national sales tax scheduled to take effect in April next year. The rating downgrade reflects the Japanese government's difficulty to balance growth and fiscal responsibility. Expectations on Japan's ability to continue to finance its debt in future were also affected by the postponed tax increase. (WSJ)

Stanchart hit with first S&P downgrade in two decades

Nov 29. For the first time in two decades, Standard & Poor's (S&P) has cut the credit rating of Standard Chartered. The rating agency cited a lower creditworthiness relative to its peers and a "tough period" the Asia-focused bank is going through. The firm's long term issuer rating was cut from "A+" to "A" and the risk position assessment for the bank was downgraded from "strong" to "adequate". S&P also mentioned that Stanchart was well funded and diversified by region and asset classes, and that asset quality should "remain steady at worst" in 2015 versus 2014. (IB Times)

Record China downgrades test PBOC as more defaults seen

Nov 28. Rating agencies say defaults in China will spread as the central bank's efforts to cut interest rate will not help much in stopping a wave of maturities from worsening. The benchmark lending rate was cut by 40bps to 5.6%, but the People's Bank of China must balance efforts to ease access to cash with steps to stem bad loans. Average debt to equity at listed companies has been increasing since 2007, and companies are estimated to repay CNY 2.1tn (USD 342bn) in the first half of 2015. (Bloomberg)

ECB could fix euro zone flaw with risk free bond (Reuters)

Venezuela bonds tumble to five-year low after crude oil drop (Bloomberg)

Regulatory Updates

UK implements extractive transparency rule

Dec 01. Under regulations that came into force on December 1, UK oil, gas, mining and logging companies will have to disclose the payments made to foreign governments by January 1, 2015. Under the rules, the companies will have to disclose details of transactions more than GBP 86,000 for taxes, royalties, permits, bonuses and the like, and they'll have to do it on both a country-by-country and project-by-project basis. (WSJ)

Getting near the end on implementing new bank capital rules

Dec 01. Canadian banks will be required to report their Basel III leverage ratio starting from Q1 2015, which is expected to exceed the minimum level of 3%. During Q4, analysts will pay attention to the banks' discussions of their liquid coverage and net stable funding ratios to see how they could affect the profitability of the firms. The Liquid Coverage and net stable funding ratios are also Basel III guidelines for banks worldwide. (Financial Post)

Fresh round of Basel III to mark boost to ME's banking sector

Nov 30. Basel III capital guidelines could help improve the asset quality and risk-return profiles of Middle East banks. Middle East banks will be encouraged to inspect and deploy capital with purposes in consistent with the bank's actual risk-return profiles and to take a more calculated and strategic approach in decision making with respect to its businesses, asset choices, and growth. (The Saudi Gazette)

Bankers doubt Indonesia's liquidity rules will have desired effect (Reuters)

EBA consults on minimum requirements for funds and eligible liabilities (EBA)

The US House of Representatives passes financial institution bankruptcy bill (Marketwatch)

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