Credit outlook of Australian and Chinese iron and steel industry to diverge amid falling demand and financing headwinds

by Alyssa Alexandra Harijanto & Wang Anyi

- **The NUS-CRI Agg Forward 1-year PD demonstrates heightened credit risk for Australian iron ore miners amidst ESG concerns, falling ore prices, and a drop in Chinese demand**
- **Despite government regulations and a slowdown in construction, the credit outlook for Chinese iron and steel is projected to remain stable driven by industry consolidation and increasing margins**

Iron ore is Australia's largest commodity export, with the nation supplying over half of the world's iron ore needs. China is the world's biggest consumer of the commodity owing to the largest crude steel industry in the world, accounting for over 57% of the global steel production. As such, China has been Australia's biggest iron ore importer, with over 60% of China's 1.17bn tonnes coming from Australian mines in 2020. The NUS-CRI Agg (median) 1-year PD (See Figure 1a) shows that the credit quality of both Australian and Chinese iron and steel[1] companies have recovered since the heights of the pandemic in Apr-2020, concurrent with rising iron ore prices caused by strong Chinese stimulus-driven demand for the commodity. However, the credit outlook of the Australian and Chinese iron and steel industry is set to diverge, with Australia demonstrating a worsening credit outlook surpassing the BB- upper bound when referenced to PDiR2.0, while China's credit profile is projected to remain stable at around 50bps in the long term (See Figure 1b[2]).

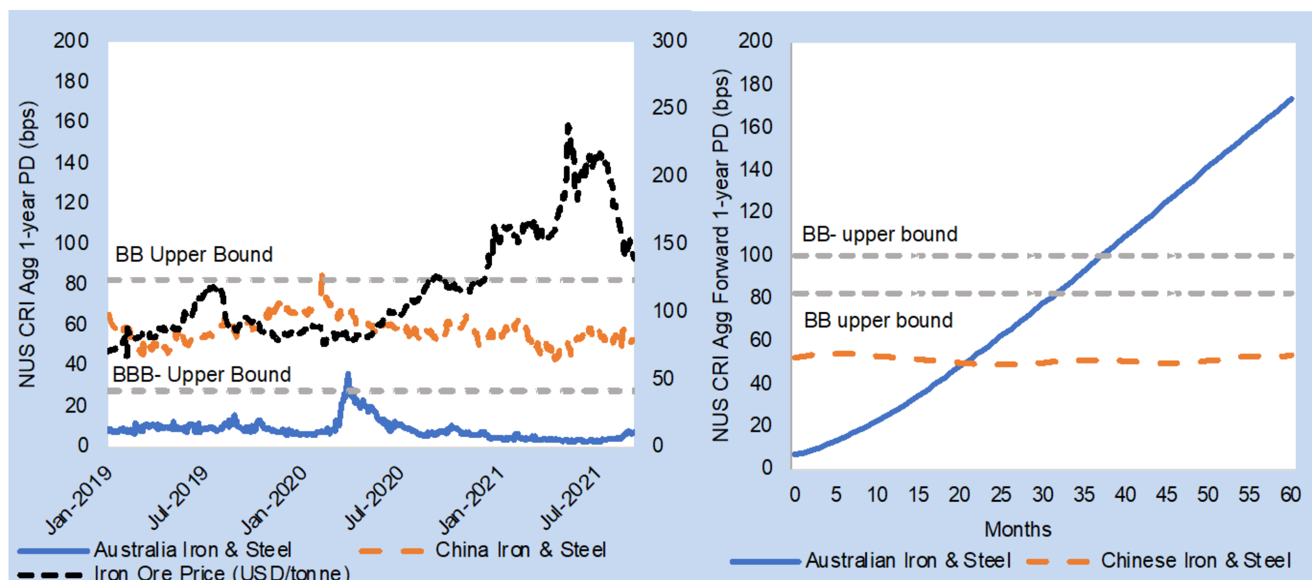

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Australian and Chinese listed iron and steel companies from Jan-2019 to Sep-2021 with reference to PDiR2.0[3] bounds (primary axis); Iron ore 62% Fe spot price index in USD / tonne (secondary axis). Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Australian and Chinese listed iron and steel corporates as of Sep-2021. *Source: NUS-CRI, Bloomberg*

[1] NUS CRI's sample consists of 28 companies for Australia and 45 companies for China.
[2] 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.
[3] 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.

As the world accelerates its transition towards green financing, Australian iron miners and steel manufacturers, which are among the worst polluting industries in the country after coal mining, may face financing headwinds in the future as the country's banks focus on enforcing stringent ESG standards. After the four biggest banks in Australia made decisions to stop lending to coal companies, it may be likely that banks could pull support away from iron and steel corporates in the future. Other financing alternatives could be limited as well, especially since the Australian government has no plans to begin tapering coal power, which is used in steel production, and the country's corporates have been slow to embrace green bonds as a source of decarbonization financing. This reduction in financing opportunities could compromise and pose a challenge to the financial health of Australian iron miners and steelmakers amidst the increased need for capital expenditure on iron ore exploration.

China, on the other hand, has made significant strides in its bid to decarbonize the steel industry, which makes up 15% of the country's carbon emissions. Under China's 14th Five-Year Plan that spans from 2021 to 2025, Chinese steelmakers are required to utilize new technology that is cleaner and less carbon-intensive[4]. Although upgrading to new machinery requires significant capital expenditure upfront, Chinese steel companies can expect continuous financing support from the government as they work towards carbon neutrality by 2060. In addition, China has planned to increase the use of recycled scrap metal in the production of steel by 23%, further reducing carbon emissions and steelmakers' dependence on iron ore. This may open doors to easier capital financing for Chinese steelmakers, especially in the context of China attracting over 83% of global ESG investment in Asia.

The surge in iron ore prices from mid-Dec-2020 to its peak of USD 233/tonne in May-2021 (See Figure 1a) has largely been driven by Chinese demand for the commodity to support its economic growth following the pandemic, and further pushed up by pandemic-driven supply chain disruptions from major iron ore suppliers in Brazil and Africa. Thanks to this rally, the value of Australia's iron ore exports to China grew by 80% YTD to USD 133bn compared to a year earlier. The record earnings boosted the financials of Australian iron and steel corporates, pushing down its Total Debt/EBITDA for the year to 0.4x compared to China's 2.3x. However, this dependence on Chinese demand poses an increased risk to Australian iron and steel moving forward, especially as the demand landscape is changing, not only due to weakening Australia-China relations, but also due to a potential fall in demand for iron ore and steel products.

Despite the Chinese government's stimulus packages boosting infrastructure demand for iron ore and steel products, demand is expected to be hindered in the near future. As the Chinese construction sector accounts for more than half of China's total steel usage, demand for steel and subsequently demand for iron ore is projected to weaken significantly. The defaults of Chinese property giants China Fortune Land Development and more recently Sichuan Languang Development underscore a wider issue with China's overheating real estate market which the government is desperate to cool down. With China tightening credit to the property sector, a slowdown in new construction projects is expected in the second half of the year as real estate developers scramble to repay and refinance their debt. In addition, China recently announced in early July that it will be cutting its steel production in 2021 to levels on par with 2020 in a bid to curb carbon emissions and to put a cap on the steadily increasing iron ore price.

[4] Electric arc furnaces use recycled scrap rather than virgin ore and are thus less carbon-intensive than blast furnaces which are powered by coal. Traditionally most steelmakers still prefer blast furnaces due to high electricity costs and insufficient scrap availability.

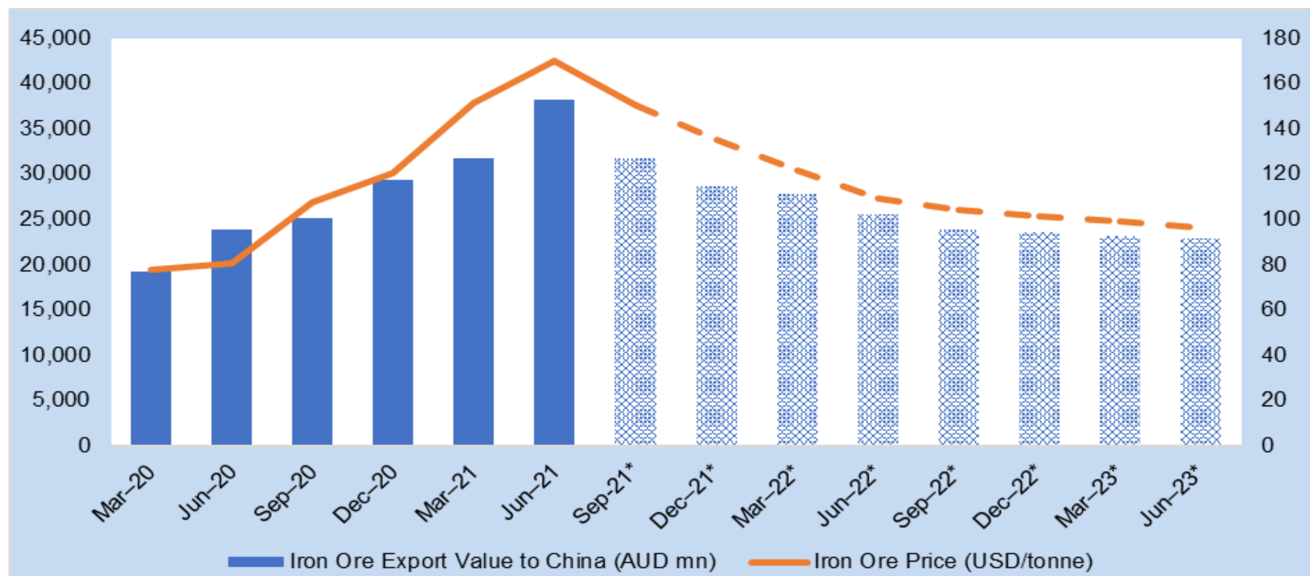

Figure 2: Australian iron ore quarterly export value to China in AUD mn from Q1 2020 to Q2 2023 (LHS); Iron ore 62% Fe quarterly spot price in USD/tonne (RHS). * denotes forecasted data. *Source: Department of Industry, Science, Energy, and Resources*

Australian iron miners have benefitted from the inflated iron ore prices this year, with the country's largest iron and steel companies announcing record profits for the year ended Jun-2021. However, this earnings performance may be difficult to replicate in the near future as the price of iron ore has declined by over 40% since its high in May-2021, reflecting the drop in Chinese demand. With iron ore prices expected to fall below USD100/tonne in 2022 and Chinese iron ore exports projected to decline by 40% in mid-2023 (See Figure 2), this could be a source of financial headwinds to Australian iron ore miners. The volatility of iron ore prices could pressure cash flow generating abilities and elevate borrowing costs for Australian miners in the future, as these capital-intensive iron and steel corporates may have less financial flexibility to handle drastic price changes. On the other hand, despite the record input prices earlier in the year, Chinese steelmakers' EBITDA margin increased to 10.5% YTD from 9.2% in 2020. With iron ore prices currently falling and steel prices rising, margins are likely to increase further, helping offset the losses caused by output cuts and falling demand and keeping the company's financial profile relatively stable (See Figure 1b).

Chinese steelmakers are aware of the risks posed to their operations and have made an accelerated move to consolidate the industry, with China's top five steelmakers planning to bump up their market share to 40% of the country's steel output by 2025. The rapid consolidation of the Chinese steel industry has aided in reducing costs associated with carbon emission reductions and strengthening margins in a competitive industry, all while cutting steel production in line with the Chinese government mandate. Although the impact of the output cuts may weigh on the companies' cash flow and profit generation in the short term, the steel industry may stand to benefit by reducing overcapacity, allowing companies to optimize their operating costs and thereby reinforcing their liquidity positions.

In addition, the Australia-China trade tensions appear to be escalating, as China has been looking to reduce its dependence on Australia for its iron ore needs and is looking towards India, Brazil and Africa, with Indian iron ore imports up by nearly 90% YoY in 2020. With China planning to develop iron mines in Africa, it would be difficult for Australia to find alternative export markets to recover its losses from its incumbent heavy dependence on the Chinese market. That being said, Australia may find a possible solution in India, which was recently announced as the world's fastest-growing steelmaker and iron ore importer out to 2026, with the potential to replicate Chinese demand for the commodity. Overall, the Chinese iron and steel industry looks poised to weather challenges presented by the decarbonization and ESG goals, as well as regulatory crackdowns, but it remains to be seen whether the country can suppress its demand for steel beyond 2021. As for Australia, although it may still face headwinds in the future, the strong earnings performance of its iron and steel corporates this year should help them overcome short-term financial woes as they face longer term structural challenges.

Credit News

Borrowers storm U.S. High-Grade bond market with 21 Deals

Sep 7. Before the Fed begins to taper, borrowers are taking advantage of low borrowing costs. On Tuesday, over 21 companies tapped the US investment-grade market, making it one of the busiest days ever in terms of deal count. Many other companies are also considering issuing new debt. The week following Labor Day is usually one of the busiest of the year. In the same period last year, 46 issuers sold over USD 68bn in new debt. Investment-grade syndicate desks of Wall Street are forecasting a volume between USD 40-45bn this week, with nearly half of that anticipated on Tuesday. The dealers are expecting a monthly volume of USD 130-140bn. For high-yield, Wall Street forecasts September sales to range from USD 35bn to 60bn. (Bloomberg)

Wall Street's ESG loans charge corporate America little for missed goals

Sep 8. An analysis by Bloomberg reveals that out of more than 70 sustainability-linked credit lines and term loans arranged in the US since 2018, more than 25% do not carry a penalty for missed goals, and attributing small discounts for targets met. As corporations try to navigate an environment of increased ESG scrutiny, they have often been criticized for presenting an overly optimistic picture of their commitments and results. Sustainability-linked loans do not restrict the use of funds but instead, link interest rates to ESG metrics. Hence, companies that meet ESG goals gain access to lower borrowing costs and face penalties if they fail to meet goals. However, the penalties are not commensurate when goals remain unfulfilled. Around 40% of the 77 credit facilities analyzed by Bloomberg, accorded a penalty of 5 basis points on failure to meet goals (Bloomberg)

Evergrande's troubles shake China's property bond market

Sep 7. Trading in China Evergrande bonds was halted for the second time in days after plunging more than 20% in Shenzhen. The turbulence came as a swiftly growing liquidity issue at the world's most indebted property developer heightened concerns. Other property developers in China have been seeing their bonds fall amidst concerns about their ability to refinance. Guangzhou R&F's bonds fell to around 60% of their face value on Tuesday. Concerns over refinancing have escalated across the sector following a persistent sell-off of Evergrande's debt and equity, which was cautioned about the potential of default last week. Last year, Beijing enacted regulations to limit developers' power that led to Chinese property developers facing tighter lending conditions amidst poorer sales. Furthermore, they are facing tumultuous trading on international markets, where they are some of Asia's largest high-yield borrowers. Evergrande's problems have pushed yields up across China's high-yield market, as the company scrambled to sell assets to raise cash to pay off its debts. According to an indicator, average rates jumped to 13% in late August from less than 10% in June. (FT)

Wall Street can't get enough Fixer-Upper houses

Sep 7. Flip loans, which are loans to fund the purchase renovation of properties, have become one of the most popular investments in Wall Street. Not only have flip loans done exceptionally well the past 8 years, with hardly any losses, they also usually carry yields of 8 to 12%, rare at a time when one-year Treasuries yield less than 0.1%. Additionally, flip loans are being repaid earlier, allowing investors to recycle capital and extend new loans to bolster returns. Recently, however, the home-flipping space has seen the entrance of new competition, including from regular homeowners armed with super low mortgages. Inventories have also become stretched thin, as foreclosure moratoriums stifled a significant source for fixer-uppers since lockdown in spring last year, making the search for property that can be renovated and resold increasingly difficult. In Q1 2021, only 2.7% of property sales were flipped, the lowest since 2000 (WSJ)

Real yields on European junk bonds go negative for first time

Sep 7. The yield on the ICE BofA index of European HY bonds stood at 2.34%, signaling that buyers accepted payments below the inflation rate of 3%. Analysts believe that the demand from investors is driven by a lack of investment opportunities in the debt markets and the belief that economic recovery in the

Eurozone combined with a solid earnings season, will prevent the default of junk-rated borrowers. The economic recovery in the Eurozone has incentivized investors to buy junk bonds as they believe that the recovery would eventually push some junk borrowers into the investment-grade territory. (FT)

Punjab National's Board approves bond plan to raise USD 816mn (Bloomberg)

Muni-Bond sales set to surge in boon to funds awash with cash (Bloomberg)

Walmart breaks green-bond record with USD 2bn debut sale (Bloomberg)

Regulatory Updates

ECB to slow bond-buying as Europe's economy improves

Sep 10. Despite the ECB's announcement that it will buy fewer bonds as a demonstration of confidence in the Eurozone's economic recovery, President Christine Lagarde of the European Central Bank assured bond investors that these are not signs of tapering. The ECB announced on Thursday that it has reduced the pace of its EUR 1.85tn pandemic emergency purchase program (PEPP) from the EUR 80bn per month it had been at since March. The price of European government bonds rose as the ECB stated it will gradually withdraw its crisis-era support for the bloc's economy. On the other hand, the central banks of Canada, New Zealand, and Australia have begun tapering their monetary policies. The ECB has EUR 500bn left to spend under the PEPP, which will last until March 2022. Even after the PEPP expires, the ECB plans to continue buying bonds. When the PEPP finishes, ECB is likely to expand and make more flexible its standard asset acquisition program, which is still running at EUR 20bn per month. (FT)

EU Bank watchdogs warn on industry plans to soften regulations

Sep 7. Twenty-five central banks and regulators in the EU urged the ECB to stick to full implementation of Basel III after the banking industry seized the opportunity during the pandemic to lobby for reduced capital requirements. With the Commission's proposal on translating the global standards into law due before the end of this year, the Basel III package will be entering a decisive phase in Europe. On one hand, banks in the EU argue that softer capital demands would aid them in extending more credit to corporates impacted by lockdowns and allow them to boost economic recovery. However, the ECB believes that a "timely and faithful" implementation of the Basel III capital rules would be necessary due to its role in the global banking system. Furthermore, regulators believe COVID-19 has underscored the need for well-capitalized banks, with more resilient banks being better able to support the real economy even during times of crisis. (Bloomberg)

Fed's Williams says 2021 taper start 'could be appropriate' (Bloomberg)

Ford's SOFR loan is first new deal to use Libor's replacement (Bloomberg)

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Contributing Editors: Yao Xuan, Raghav Mathur