Small US oil and gas corporates become increasingly riskier relative to their bigger peers as funding pressures mounted

by Anthony Prayugo

Outlook for the US oil and gas corporates is increasingly gloomy amid growing consensus of forecasts that oil and gas prices will stay low for several years. Default risks for small oil and gas corporates in the US (firms with market cap of less than USD 1bn as of Nov 2019), in particular, were elevated as they are struggling to service debt and secure new funding. Tracked by the NUS-CRI 1-year Aggregate Probability of Default (Agg PD) below (Figure 1a), the Agg PD for small oil and gas corporates in the US began to surge upwards in May 2019 as the oil price slipped below USD 65 per barrel and its Agg PD has hovered at around 180bps ever since then. In tandem, the proportion of junk-rated corporates (rated BB positive and lower) for small US oil and gas corporates has increased from approximately 50% earlier last year to around 75% according to the NUS-CRI Probability of Default Implied Rating[1] (PDiR) in Figure 1b below.

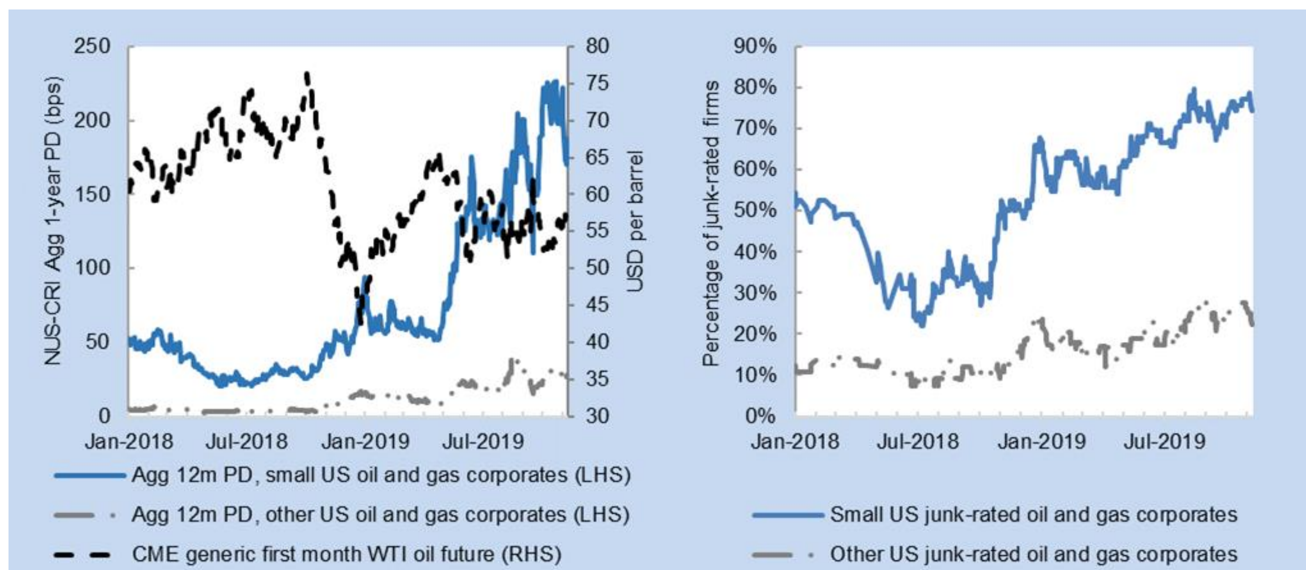

Figure 1a (LHS): NUS-CRI Aggregate 1-year PDs for US oil and gas corporates from 2018 and West Texas Intermediate crude oil future. Figure 1b (RHS): Percentage of junk-rated US oil and gas corporates according to PDiR. Source: *Bloomberg*, *NUS-CRI.*

As oil prices stay below USD 60 per barrel, some oil and gas corporates are struggling to meet their obligations. Many US oil and gas corporates are highly leveraged and those that took on debt in the aftermath of the 2016 oil slump will face waves of debt maturities in the next four years. A report by S&P in July 2019 stated that USD 137bn worth of bonds will be due between 2020 and 2022, making it necessary for those corporates to look for new funding and refinance their debt. However, this might prove to be challenging for smaller US oil and gas corporates amid the pessimistic outlook on oil prices.

Small US oil and gas corporates are more affected compared to their bigger counterparts partly due to having more restricted access for funding. Unlike their larger counterparts, smaller US oil and gas corporates are struggling to raise funds from issuing stocks or bonds as investors grew restless with years of low returns in the sector. Many smaller US oil and gas corporates, therefore, rely on the reserve-based loans (RBLs) that are

[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 historical observed default rates of S&P's rating categories.

provided by banks as a source of funding. Banks make estimation of the values for oil and gas corporates' reserves as a basis for companies to receive the RBLs. To reduce their risk exposure on the oil and gas sector, some banks, such as JPMorgan Chase and Wells Fargo, cut their estimated values for oil and gas corporates' reserves. For instance, expected natural gas prices have been cut by around USD 0.5 per million British thermal units which is about 20% below levels set in spring and oil prices are expected to be about USD 1 to USD 2 lower than spring estimates. It was forecasted that affected corporates could face a 15% to 30% reduction in loan size as a result.

For firms that are able to issue bonds, the yield spread between the small US oil and gas corporates and their larger peers has in general widened this year, indicating that investors increasingly require to be compensated with higher returns to invest in smaller firms. Despite overall corporate high-yield bond issuances rose 32% in the middle of this year, issuance for high-yield energy bonds fell 40% compared to last year (most small US oil and gas corporates are considered junk-rated). Take the yield-to-maturity (YTM) for some small and big US oil and gas corporates for comparison purpose. As shown in Figure 2a below, the average YTM for the small corporates has increased in general since 2018. In contrast, the average YTM for the large corporates has moved in the different direction, causing the yield spread between them to widen. One probable reason why larger corporates are outperforming their smaller peers is due to already having integrated well-to-refinery networks to control costs enough to withstand a sustained period of low prices. Unlike smaller oil and gas corporates, large oil and gas corporates have been largely more successful in using economies of scale, better technology and larger contiguous plots of land to cut costs.

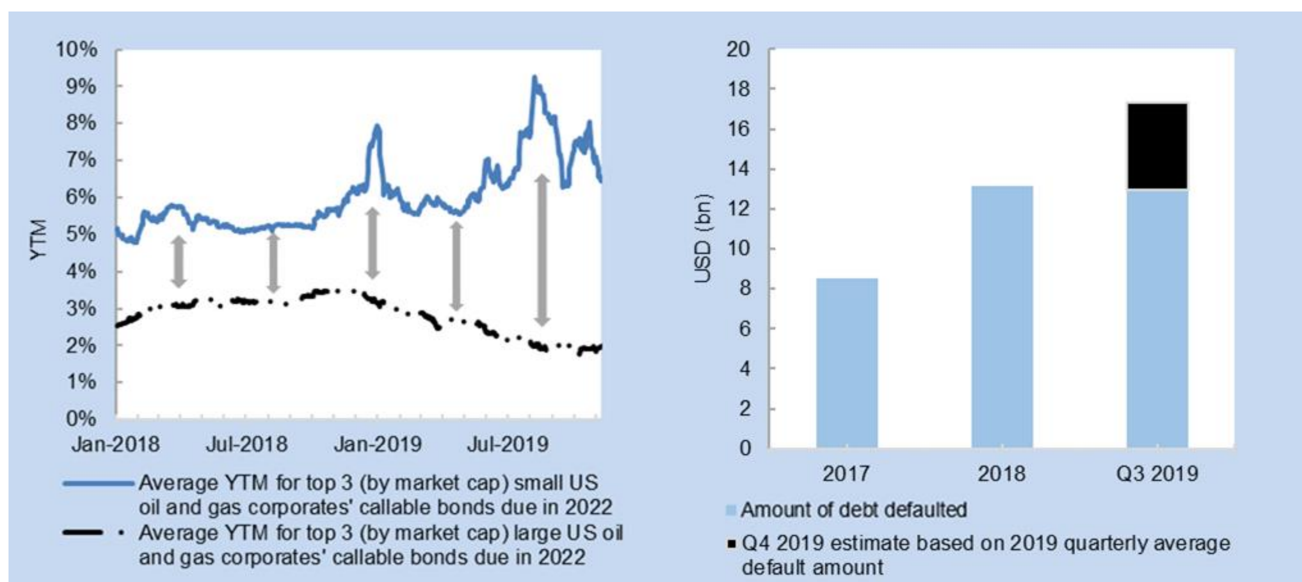

Figure 2a (LHS): Average yield-to-maturity of a selection of USD bonds issued by some small and big US oil and gas corporates. Figure 2b (RHS): Amount of debt defaulted by US oil and gas corporates as of Sep 2019. Source: *Bloomberg, Haynes & Boone Bankruptcy Monitor.*

Moving forward, concerns over a potential oversupply of oil worldwide remain as Russia, the world's second-biggest oil producer, is unlikely to back deepening output cuts when the Organization of the Petroleum Exporting Countries meets in December. On the demand side, the US crude demand has slowed amid the protracted US-China trade war as hopes for an end to the dispute in the signing of a so-called Phase One agreement could dim due to disagreements over the removal of tariffs. These uncertainties could further depress the oil price and combined with the increasing funding pressures, threaten more bankruptcy in the oil and gas sector. The amount of debt defaulted by US oil and gas corporates through the end of the third quarter this year have nearly matched the total for the whole 2018 amid signs of downturn in the oil price (see Figure 2b).

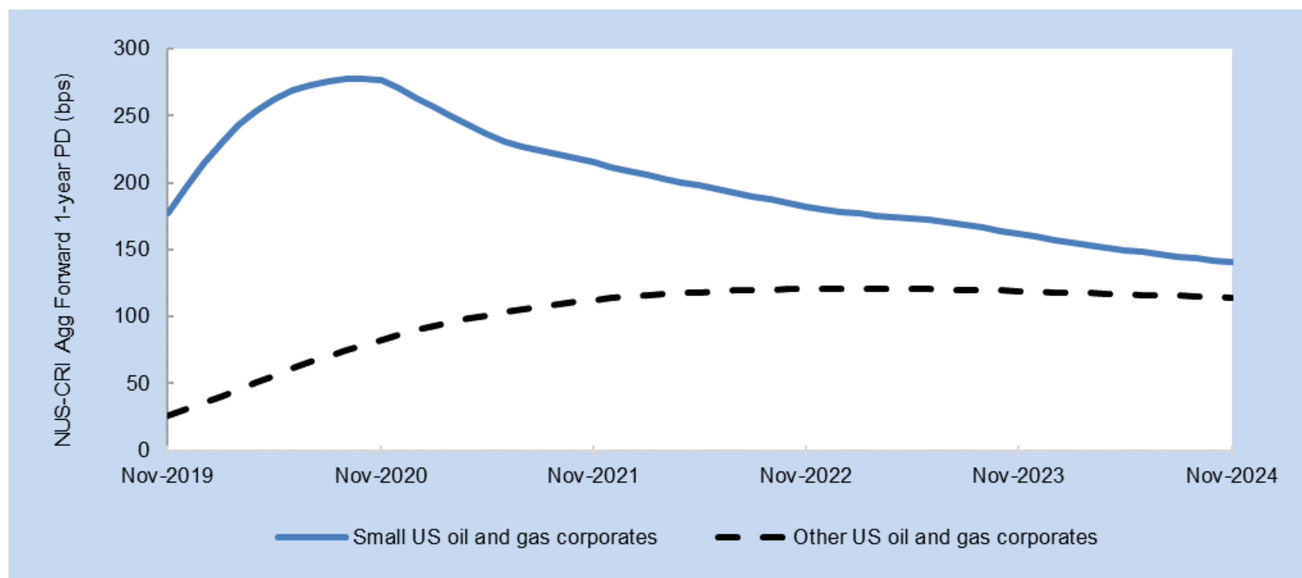

Figure 3: NUS-CRI Forward 1-year PD term structure of the US oil and gas corporates based on information in Nov 2019. Source: *NUS-CRI*

In all, the market is bearish about the credit outlook for the small US oil and gas corporates for the next year. Figure 3 shows that their Aggregate (median) Forward 1-year PD[2] (Forward PD) will continue to deteriorate at a faster level compared to their larger peers in the next 12 months. At the peak point in Oct 2020, today's market expects a probability of 2.8% for a typical small US oil and gas corporate to default in the next one year given it survives till Sep 2020. However, if the small US oil and gas corporates can survive through Oct 2020, their credit risk will decrease and converge towards their larger peers' Forward PD level in the four years after that.

Credit News

As everyone else wins, lowest-rated junk bonds get hammered

Nov 23. The high-yield bond market gets hammered while the economy is humming and the stock market is hitting new highs. Investors have been demanding significantly higher yields to lend to a list of riskier junk-rated issuers so that the spreads in the riskiest tier of junk debt breached 1000bps for the first time in more than three years. Still, the junk bond market has tilted toward higher-quality in the last five years, and the turmoil is largely being regarded as an isolated event, since the biggest selloffs are concentrated in companies with troubles specific to themselves. However, it is noticeable that downgrades in the speculative-grade debt market are outpacing upgrades by the most since 2009, and defaults have spiked for both bonds and loans, amid fears of an economic downturn persist. (Bloomberg)

Trump tax cut sets off boom in once sleepy corner of muni market

Nov 22. The taxable municipal bond market is luring investors by a deluge of debt sales unleashed this year. The surge in issuance is a side effect of President Donald Trump's 2017 tax-cut law which deprived states and cities the power to sell tax-exempt bonds for a key refinancing technique. However, rates have fallen far enough that municipalities can even sell taxable bonds to pay off old debt, resulting in the swift pace of issuance. Consequently, yields on certain taxable munis have been pushed up. Amid concerns about economic growth and the large pile of debt many businesses have amassed, the relative safety and high

[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 12-month Forward 1-year PD is the probability that the firm defaults during the period from 12 months onwards to 1 year plus 12 months, conditional on the firm's survival in the next 12 months

returns of the muni-debt holdings have attracted several corporate-bond buyers such as banks, insurance companies, and pension plans to invest in these assets. (Bloomberg)

Lenders brace for private-equity loan defaults

Nov 22. The default risk of companies owned by private-equity firms is 2.5 times that of their public counterparties, and financial institutions raised their estimates of the average probability of default for private-equity firms' loans. The jump in the default risk of private-company loans compared with public ones shows there is a potential for things to deteriorate much faster, especially in a down market. This could have more impact on global finance than in years past because there are far more of the loans in existence and they are broadly held by mutual funds. Worries mount about a turn in the credit cycle and a rise in corporate distress. (WSJ)

Japanese whale of the CLO market signals end to buying binge

Nov 22. Norinchukin Bank, the Japanese agricultural lender that has become the world's largest holder of CLO, has called time on its buying spree, raising questions over the outlook for this hot class of assets. Norinchukin reported a drop in its holdings of CLOs for the first time in over a year and said its CLO holdings had almost peaked, cited the thinner income on offer from CLO due to falling interest rates and increased demand from investors. The Bank of Japan warned last month that the country's financial system is becoming more susceptible to the effects of stresses abroad, considering that domestic lenders now hold about 15% of the global market for CLOs. (FT)

Money pours into US corporate debt despite warnings

Nov 21. Investors have poured USD 180bn into US bond funds so far this year, even as the extra returns on offer have shrunk and warnings over mounting risks are have been raised. The rush into the corporate bond market reflects investors' ongoing need for yield when interest rates remain at very low levels. Companies have taken advantage of the low-rate environment to raise cash from investors. However, Fed officials raised the concern that the imbalances in the corporate debt market had grown over the economic expansion, and the deteriorating credit quality could lead to sharp increase in risk spread in the corporate debt market. (FT)

Biggest Australia bond rally since 2014 drives Japan funds away (Bloomberg)

Vale returns looking for low-cost debt after Brumadinho's tragedy (Reuters)

Seadrill in talks with banks to restructure debt (Reuters)

Regulatory updates

Bank Indonesia cuts reserve ratio in cautious easing move

Nov 21. Indonesia's central bank left its seven-day reverse repurchase rate unchanged at 5%, while cut the reserve ratio by 50bps to pump more liquidity into the financial system. The central bank is taking a more cautious approach to stimulate the economy after 100bps of rate cuts since July. Cutting the reserve ratio while holding key interest rate unchanged fit into the central bank's objective of promoting credit expansion and maintaining rupiah stability. Going forward, Bank Indonesia will monitor domestic and global economic developments in using its room to implement an accommodative policy mix. (Bloomberg)

China cuts interest rate slightly in latest fine-tuning of economic stimulus

Nov 20. China made a slight cut to its one-year and five-year Loan Prime Rate by 5bps on Wednesday as expected, and the central bank ordered state-owned lenders to align their loan rates to this benchmark. Beijing has avoided large policy measures to counter the economic slowdown, but has taken a series of incremental steps to fine-tune policy, indicating that the central bank has been taking a more proactive approach to nudging down borrowing cost. It is still unclear whether slightly lower interest rates will spur more bank lending to support the economic growth. (South China Morning Post)

Thai central bank to ease FX rules due to limited scope on rates (Reuters)

Fed adds USD 80.6bn to financial system in latest repo transactions (WSJ)

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Contributing Editor: Luo Weixiao