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Weekly Credit Brief Oct 23 - Oct 29

China increases appetite for natural gas as it seeks to replace coal

by Zhou Ye

Environmental concerns are driving China's rising imports and production of natural gas, which is a cleaner source of fuel compared with coal. The nation's demand for natural gas surged due to its coal to gas switching policy. To meet its huge demand, China expanded its natural gas imports and is on track to overtake South Korea and Japan to become the world's largest importer of natural gas for the first time in history. Meanwhile, China's five-year gas plan targets to produce more gas indigenously.

From the RMI-CRI 1-year aggregate Probability of Default plots shown in Figure 1, the median default risk for China's Energy Industry, which covers all ranges of energies including the Alternative Energy Industry, are significantly higher than natural gas companies, indicating a lower credit risk of the natural gas industry.

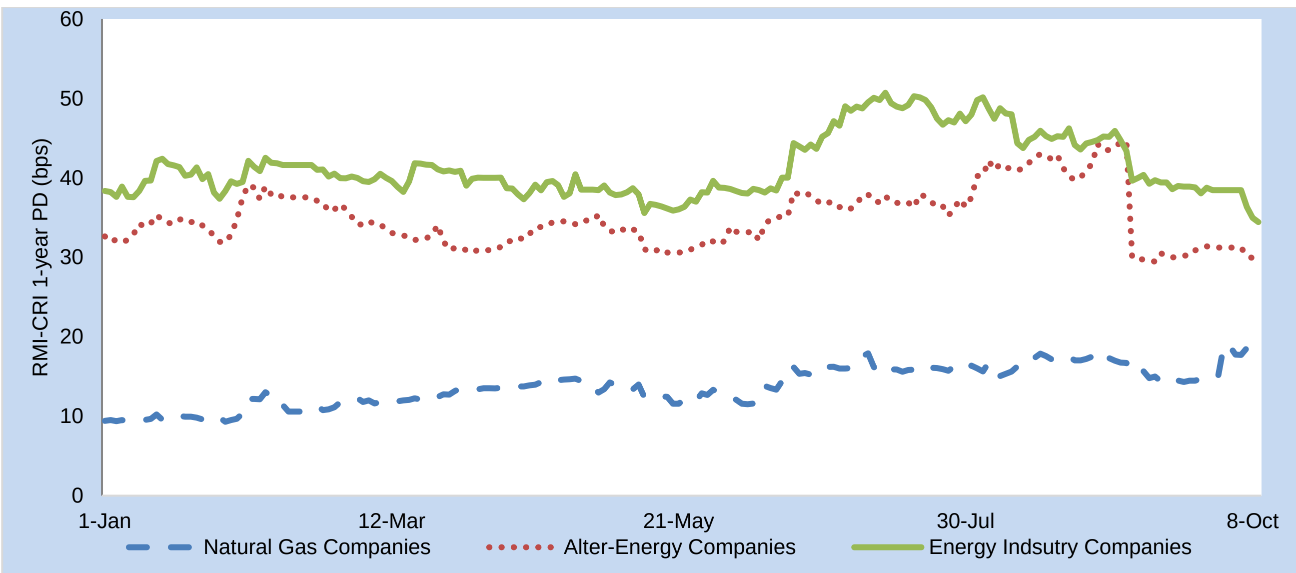


Figure 1: RMI-CRI 1-year Aggregate PDs for China's Energy sub-sectors. *Source: RMI-CRI*

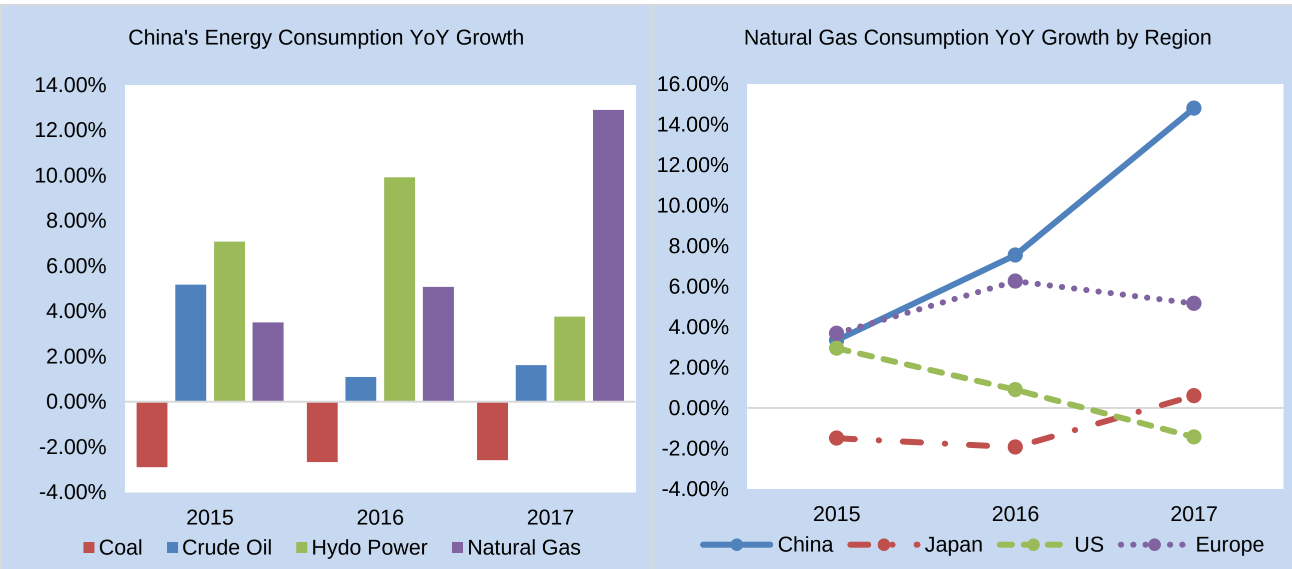
In recent years, China has shown a rapid growth trend in natural gas consumption, due to its improvement of atmospheric treatment demand and the impact of the energy structure upgrading strategy. In 2012, natural gas only accounted for 4.9% of China's total energy consumption. With its "coal to gas" strategy progressed to a stage high in 2017, the country's natural gas consumption achieved 240.4bn square meters, significantly higher by 14.8% from 209.4bn cubic meters in 2016. In addition, with the coming of winter this year, residual heating issues may arise. Over 120bn cubic meters of natural gas will be distributed nationwide during the winter, of which over 40% is for residential use. As part of its anti-air pollution campaign, China has ordered 1.18mn residential households in 11 cities to switch to natural gas heating for the coming winter and targeted a carbon emission reduction of 3-5%.

Increased natural gas share has benefitted the China's natural gas industry. Table 1 shows information of the large companies focusing on natural gas in China. The financial figures show an increasing trend in revenue in 2018, which are 36.9%, 33.8% and 38.9% for China Gas Holding, ENN Energy and Shanodoing Sheng Li, respectively. The companies' EBITDA also increased by 60%, 23% and 42%, respectively. Meanwhile, China Gas Holdings generated a lower Net Debt/Equity, suggesting a better credit outlook.

	Revenue (CNY mn)			Net Debt/Equity (%)			EBITDA (CNY mn)		
	2016 1H	2017 1H	2018 1H	2016 1H	2017 1H	2018 1H	2016 1H	2017 1H	2018 1H
China Gas Holding	30239.8	28795.3	39420.0	77.7	80.8	66.6	2774.5	2968.4	4757.6
ENN Energy	31815.0	39888.0	53375.0	48.5	49.9	50.3	3190.0	3015.0	3707.0
Shandong Sheng Li	2203.0	3094.3	4299.2	16.4	21.8	52.7	-9.9	145.7	207.3

Table 1: Financial Figures of China Natural Gas Companies. *Source: Bloomberg*

The huge demand also bolsters China's natural gas import and domestic production. According to the International Energy Agency, China could surpass Japan to be the [world's largest natural gas importer](). In 2017, China's imported 94.6bn cubic meters of natural gas up 26.9% YoY as natural gas demand increased by 39%. In its five-year gas plan projects, China targets the demand for natural gas to reach 360bn cubic meters, up from 207bn cubic meters in 2016. Meanwhile, it sets a goal to produce 207bn cubic meters indigenously to meet the demand.



Figures 2a-2b: Change of China's Energy Consumption between 2015 and 2017. *Source: International Energy Agency*

Current policies are favorable towards China's natural gas producers. In the [Nationally Determined Contribution]() (NDC) climate pledge under the Paris Agreement, China agreed to increase its share of natural gas consumption in the primary energy mix from 6% in 2016 to 10% by 2020. The target also appeared in the country's 13th Five-Year Plan for Natural Gas Development. These policies could help build up investor's confidence in the industry.

Looking ahead, one of the risks is the ongoing trade war between the US and China as recently China announced [counter measure tariffs]() in response on billions worth of US imports including a 10 percent tariff on liquefied natural gas. However, currently US LNG imports only account for 4% for China's total LNG imports and it may not affect the credit quality of China's natural gas firms much.

Credit News

How rating agencies work and why they are feared

Oct 27. Credit rating agencies are paid by governments and corporations to judge the creditworthiness of their debt. A weak report will make borrowing more costly as it will push the borrowing rates higher while a strong one can bring borrowing rates down. As political developments, major social and economic events or a large company acquisition can all trigger notation updates, agencies regularly revise their ratings. S&P on Friday increased pressure for Italy as it downgrade its outlook for Italy's sovereign debt which have an impact on markets and investment decisions. Credit rating agencies' reputations were badly hit by the 2008 financial crisis when they failed to notice the risky subprime assets. Consequently, European leaders had called for the creation of an independent European body to break the US rating agency monopoly but that idea has not been followed up by action. ([Business Times]())

Janet Yellen sounds alarm over plunging loan standards

Oct 25. The former chair of the Federal Reserve warned about the systemic risks associated with the loosening standards in the leveraged loans market, in particular the loosened covenants in leveraged lending. Regulators have insisted on banks holding appropriate capital against leveraged loans against their balance sheet but much of these debt were being repackaged and sold on. Ms Yellen also commented that the lack of macroprudential tools in the US that regulators could use to curb risk is also worrying. These comments come amid a push to water down reforms that were in place since the financial crisis and a bill to adjust the size at which banks are subject to regulatory scrutiny and easing some rules for small lenders. (FT)

Bondholders raise hopes Venezuela will pay up on due debt

Oct 25. A 2020 bond issued by Venezuela's state oil company PDVSA has rallied 14% in six weeks to trade at over 91 cents, up from a year low of 80 cents in early September amid the hammering of other emerging market government bonds. Investors are convinced that PDVSA will come up with the USD 842mn principal payment due this weekend to avoid default and losing its US-based refiner Citgo, a key asset. If PDVSA fails to pay, bondholders can go after half of Citgo which has been pledged as collateral. However, even if it manages to make this payment, Venezuela and PDVSA will still need to find more than USD 9.3bn and USD 10bn to pay their bondholders in 2019 and 2020 respectively. This bleak prospect has forced Venezuela to consider declaring PDVSA bankrupt and replace it with a new national energy company that will inherit PDVSA's physical assets, including Citgo, but not its debts. (FT)

Italian families, firms feel heat of rising bank loan costs

Oct 25. Families and firms are facing a higher borrowing cost from bank after a fall in the value of the country's bonds, the first sign of a credit tightening. The falling government bond prices eat up banks' capital and rising yields lift funding costs, leading to pricier loans and lower lending capacity. Firms are also saying that banks are demanding repayment. Banks' concerns over souring loans also result in credit curtailment. Looking forward, a tighter credit environment is expected because of the unpredictable outlook. Businesses being surveyed in September had also signaled a slight worsening in credit conditions. (Reuters)

Record China bond failures breathe life Into CDS-like tool

Oct 24. Corporate debt investors are reaching for hedging tool similar to credit-default swaps (CDS) amid the spiraling bond defaults in China, which has amounted to a record USD 9.5bn this year. Since September, China Bond Insurance Co. and Bank of Hangzhou Co. have sold four risk hedging instruments called credit risk mitigation warrants (CRMW), with analyst expecting rising demand and thus greater prospect for such tools. CRMW offers market participants a public process to determine pricing similar to book-building for a bond while CDS prices are set by negotiations between counter-parties which makes the market less transparent. (Bloomberg)

Netflix piles up on debt with new USD 2bn IOU (The Straits Times)

Mitsubishi Heavy's struggling aircraft unit to gain USD 2bn lifeline: NHK (Reuters)

ECB to focus on bond-buying exit as threats mount (Business Times)

Regulatory Updates

EU states close to a stricter backstop plan for bank bad loans

Oct 26. European Union states are close to a plan that would give banks only seven years, down from eight years, to build a backstop against bad debt. If adopted, the rule is expected to cause further trouble for Euro zone banks which are yet to recover from the 2008 Global Financial crisis. Under the new rule, new assets of banks that do not build a sufficient backstop will automatically be devalued. Euro zone banks still hold EUR 731bn of debt that they might not be able to recover based on European Banking Authority's latest data with Greece and Italy being the worst performing. (Reuters)

China's central bank to offer more funds for private firms

Oct 23. China announced fresh measures, including supporting bond financing by private firms, granting initial funding to financial institutions and increasing re-lending and re-discounting quota for the central bank, to ease the funding strains of private companies. Life for private companies has been tough this year because of the trade war and the government's campaign to curb debt and cut the shadow banking. The measures are expected to restore confidence, help avoid systemic default risk, and also represent the "unwavering" support for the private sector vowed by the President Xi. (Business Times)

Bank of England checking lenders' easy-to-access liquidity (FT)

Open rift between Indian central bank, government as official warns of catastrophe (Straits Times)

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