S&P Global
Ratings

Corporate Top Trends Update

Asia-Pacific Credit Outlook 2023

Sand In The Gearbox

Feb. 21, 2023

This report does not constitute a rating action

Asia-Pacific
Slowing Earnings Leave Ratings Untouched--For Now

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Key Takeaways

- Slowing economies and weakening demand are likely to dominate corporate operations across much of Asia-Pacific in 2023. High inflation further inflames conditions.
- Borrowing costs will increase for many corporates as interest rates continue to rise. Access to U.S.-dollar funding will remain tight, with domestic markets and bank funding more favorable.
- Uncertainty surrounds China's expected economic performance for 2023 given the scrapping of its zero-COVID policy, the global outlook, and risks around domestic property policies.
- Japan has the lowest percentage of stable outlooks and highest proportion of negative outlooks whereas India and Indonesia have no negative outlooks.

Economic conditions are tough across markets. The global economy is slowing, and domestic economies are sluggish. This combination will equate to modest revenue and profit growth in many Asia-Pacific countries in 2023. Corporates face a cocktail of high inflation, elevated costs, weak consumer demand, and increasing debt-funding costs. Despite this, however, we expect slight credit improvement overall in Asia-Pacific. Companies have focused on capital management to help alleviate credit pressures; and debt due for refinancing is lower this year than in 2024 and 2025. Offshore funding will nevertheless remain a relatively expensive sticking point for many corporates.

Sector performance will be patchy. Australian oil and gas producers and metals and mining companies should experience continued elevated prices even if down from recent peaks. Chinese manufacturing may take longer to recover if global conditions affect demand in export-related sectors. Indian airports are poised for strong performance on the back of healthy domestic traffic and a recovery in international traffic. Credit conditions for Japanese electric utilities will be tough as high fuel costs and a weaker yen affect cost lines. South Korean utilities and technology companies face adverse market conditions, which pose risks to ratings. Conversely, Korean automobile makers and electric vehicle-related companies are likely to experience better operating conditions. The outlook for real estate is bumpy amid higher interest rates. Lease and leverage profiles will determine susceptibility to rating changes.

Rating outlooks have nevertheless improved from last year. The bulk of ratings are stable. About 10% of the portfolio have a negative outlook compared with about 15% at the corresponding time last year. Japan has the highest proportion of negative rating outlooks in the region: almost 25%. The sectors with the highest share of negative outlooks are healthcare; mining and minerals; and real estate. Three quarters of the Asia-Pacific credits we rate are investment grade ('BBB-' or above). At the other end of the spectrum, the share of ratings at or below 'B+' is about 10%.

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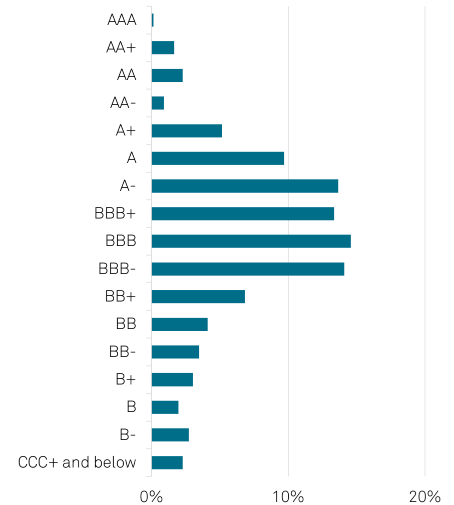

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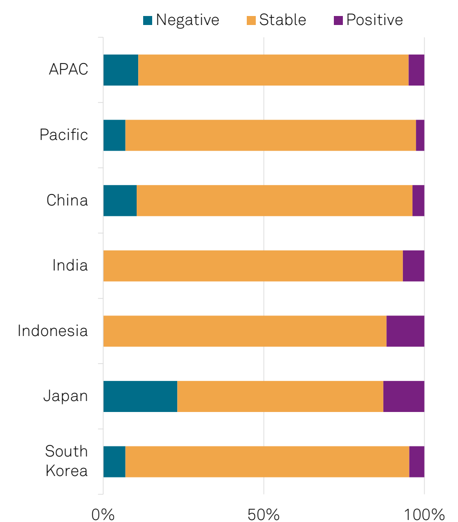
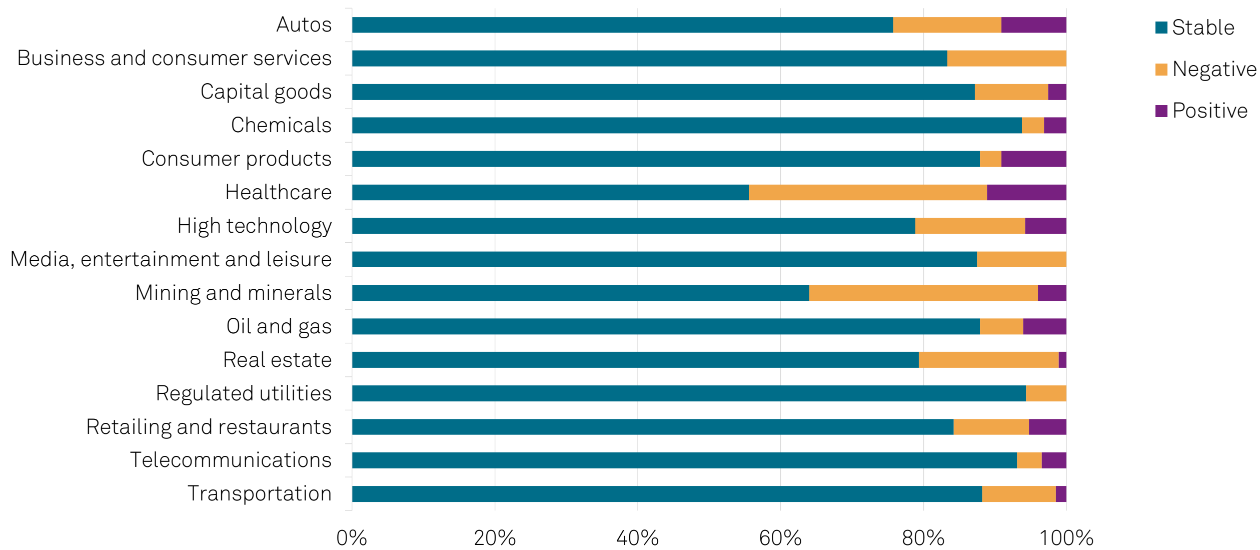


Source: S&P Global Ratings.

Chart 1

Sector Performance Is Uneven

Overall rating outlooks have improved

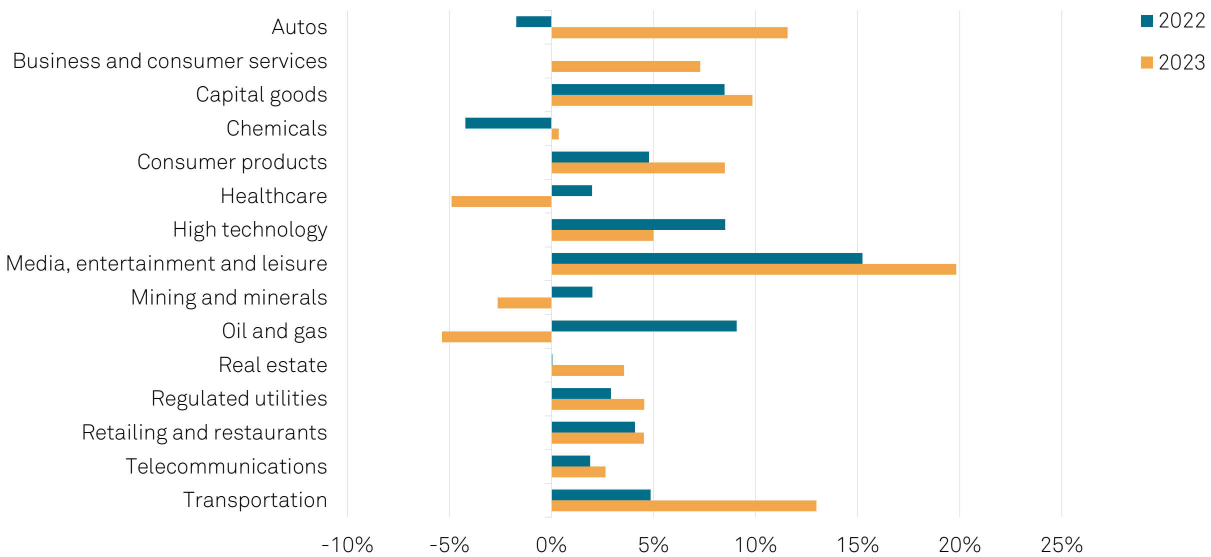


Source: S&P Global Ratings.

Chart 2

EBITDA Median Growth

% YOY



Source: S&P Global Ratings.

Australia & New Zealand

It's All About Inflation, Rising Interest Rates, And China

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Key Takeaways

- Elevated inflation and high interest rates will dominate in 2023. Slowing demand will bite across consumer-facing sectors as savings balances fall and individuals adjust to higher mortgage rates and costs of living.
- Energy prices will remain high. Oil and gas producers should still see strong profits despite price caps and related regulation. Companies with contracted energy input prices will be protected but consumers will face higher electricity and gas costs, adding to cost-of-living pressures.
- The rate at which China recovers will be a key influence on iron ore, coal, retail, and tourism and travel.
- The rating outlook remains overwhelmingly stable but consumer demand, higher operational and funding costs, and supply chain woes may test this.

Many corporates will grapple with high inflation and rising rates. Expected persistent high inflation throughout 2023 will continue to squeeze operating margins. Prone to this are sectors with less ability to pass on higher costs to end consumers. Problems passing on higher prices could become more acute as demand slows, particularly in sectors with strong competition or high price elasticity. The sectors most likely at risk from higher costs are discretionary retail, consumer products, and entertainment and leisure. On the funding side, highly levered Term Loan B issuers remain the most exposed to higher rates and the slowing macro environment.

Consumer demand to slow. Despite low consumer confidence data, consumer spending remained robust during the second half of 2022. However, we expect consumer demand to weaken in 2023 as household savings balances erode and cost pressures intensify. The higher cost of living will affect many households via a combination of higher mortgage rates (especially as fixed rate mortgages expire), high energy prices, and elevated food and transport costs. Sectors likely to be most affected are discretionary retail, leisure, durable goods and transportation.

China's economic growth rate will be a swing factor for many parts of the Australian corporate landscape. We expect the accelerated reopening of the Chinese economy and the end of zero-COVID to spur the country's growth, albeit from a low base. The associated increase in mobility, economic momentum, and the eventual stabilization of China's housing market will in turn support Australian commodity prices beyond the forecasts in our base case. Additionally, the expected increase in inbound tourism from China will be crucial to the recovery of Australia and New Zealand's international airports. There is a risk that a more rapid recovery in China could stoke inflation.

Geopolitical factors are shaping the outlook for the oil and gas and metals and mining sectors. China's COVID policy shift coupled with supply disruptions from the ongoing Russia-Ukraine war will cause volatility in commodity prices. We anticipate gas producers will benefit from natural gas prices remaining elevated well into 2024. This is because Europe will look to replenish its gas inventories for the winter, this time with much lower reliance on Russian supply. We project near-term oil prices will continue to buttress credit quality. Tight global supplies as well as China's COVID reversal will provide support for oil prices for now.

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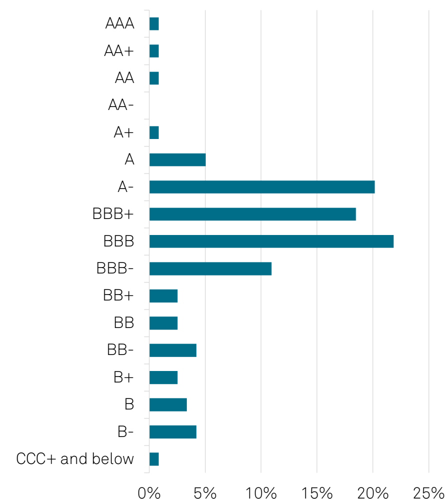

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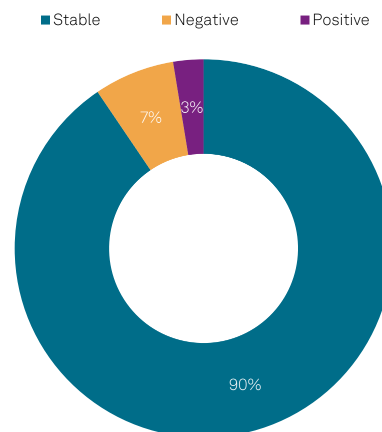

Source: S&P Global Ratings.

The global metals and mining sector has built a solid buffer in ratings. This follows several years of robust earnings and cash flows that have led to progressively lower leverage. Prices for most metals fell during 2022 amid a weaker economic outlook. However, they remain higher than previous troughs because supply is relatively tight given the capital discipline of the large mining companies.

Rating outlooks remain mostly stable. Approximately 90% of the rated portfolio has a stable outlook, up from about 80% at the corresponding time in 2022. The negative outlooks span various sectors. We expect the slight negative outlook bias to persist in 2023 given the effect of rising interest rates and inflation on the broader corporate sector

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REITs To Feel Rates Bite

Rising interest rates pose cashflow risks for REITs generally, but many benefit from near-term hedging, long leases, and rent escalators. Valuation divergence between public and private real estate markets could add to redemption and gearing pressure for unlisted funds. Some private REITs are experiencing increased unitholder redemption requests, which is likely to exacerbate cashflow and liquidity constraints. We expect hybrid and work-from-home trends to crimp longer-term demand for office space although high quality office assets should offer some protection against this evolving trend.

In our view, asset sales or other capital raisings will likely occur in order to fulfil redemption requests. Amid higher interest rates and volatile swings in asset valuations, we do not expect REITs to favor debt drawdown to fund redemptions. Asset divestments may be limited by demand and capital allocation toward the sector, which could pressure asset prices.

Our rated issuers generally have sufficient balance sheet liquidity and headroom in their credit metrics and covenants, with the support of quality assets. We expect these issuers to actively manage their redemption and liquidity requirements, exercising additional levers and capital management initiatives where required.

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Telco Revenues To Benefit From Demographic Trends

The return of international students and a boost in tourism will increase population. In addition, consumer price index-driven price increases could provide additional revenue momentum. Price increases have begun to flow; and higher priced 5G phone plans will deliver further impetus. Telcos are relatively recession-resistant given consumers and businesses are unlikely to reduce their connectivity. However, a sustained period of inflation that increases the cost base could erode margins. Furthermore, subscriber trends may weaken. Interest rate rises may reduce consumers' discretionary income thereby causing them to defer upgrades or migrate to cheaper plans or operators.

China
Focus On Growth As The COVID Cloud Lifts

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Key Takeaways

- An earlier-than-expected exit from zero-COVID bodes well for domestic growth and the recovery of China's corporate sector.
- We expect property sales to remain weak and the government to help stabilize the sector by providing financing support. Property developers account for nearly 40% of Chinese corporates with either a negative outlook or on CreditWatch.
- An easing in interest rate rises may boost investor sentiment and improve access to offshore funding.

China is exiting from its zero-COVID policy earlier than we expected. New infections have spread following the relaxation in December 2022. However, we believe the resulting impact will be manageable and transitory, as winter is the low season for many sectors, and we do not expect the Chinese government to reverse its COVID easing. Given this, GDP growth will accelerate to our base case of 4.8% in 2023. The rebound in mobility and business activity after nearly three years of recuring lockdowns may allow Chinese corporates to recover faster than we previously expected, particularly sectors that are more reliant on people mobility.

Revitalizing economic growth is the government's key focus in 2023. The Central Economic Work Conference held in December 2022 signaled a refocus on economic growth. This implies lower policy risk for corporates. The "platform" or online economy, an area that has undergone meaningful regulatory tightening in the past three years, was specifically named for more support. Preventing systemic financial risks is also among the government's priorities in 2023. To achieve this, we expect the government to launch more supportive housing policies to stabilize the property sector.

Negative outlook bias indicates ongoing downside risk. We maintain a net negative outlook bias for our ratings on Chinese corporates despite some improvements since mid-2022. Currently, about 35% of our ratings on speculative-grade Chinese corporates carry negative outlooks. This contrasts with about 5% for investment grade, suggesting the former to be six times as likely to see downgrades in 2023. Property developers, in particular, account for nearly 40% of Chinese corporates with either a negative outlook or on CreditWatch.

Uncertain global economic backdrop. Tightening of monetary policy globally is dampening demand and exacerbating global recession risks. China will gain domestic growth momentum from its earlier-than-expected exit from zero-COVID, but a weaker external environment remains a material risk. The country's reopening could cause higher commodity prices and other inflationary impulses, which could keep global rates higher for longer. In such a scenario, weaker external demand could affect exports and slow the topline recovery of Chinese corporates, particularly those in manufacturing.

Geopolitics tensions to remain high. U.S.-China disagreements and strategic competition are likely to remain key risk drivers throughout 2023. Consider, for example, the U.S. tightening export restrictions on advanced semiconductor technology to China. This raises the need for more capital expenditure (capex) and

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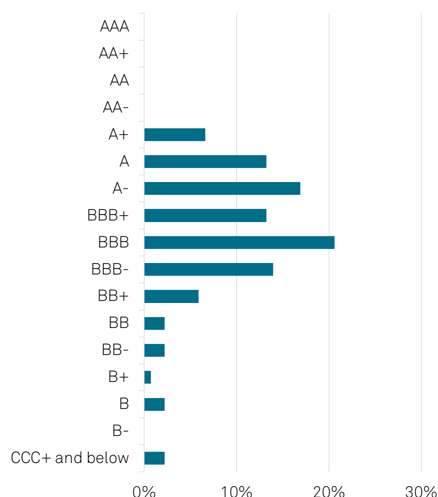

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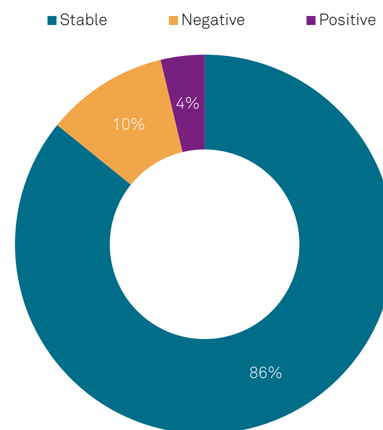

Source: S&P Global Ratings.

investments in related sectors over the medium to long term. This could weaken the credit fundamentals of affected tech issuers. U.S. collaboration with other tech-exporting countries in Europe and Asia to broaden such measures may add to these pressures.

Government may have to support state-owned enterprises (SOEs) again. Government support for SOEs will remain selective in the face of widening deficits and deteriorating fiscal conditions. Revenue from land sales is unlikely to recover quickly, while the burden of stimulus policies may fall on localities as part of the central government's push to stabilize growth. This combination may keep the leverage of weaker SOEs high and the risk of distress material. While defaults of SOE bonds have remained at a very low level in the past two years, recent reporting of late commercial bills payments and bank loan restructurings indicate underlying distress. More such cases could emerge in 2023.

Property policies entering an easing cycle. A slew of supportive policies has helped slow the downward spiral in China's home sales. These measures are mainly market-based approaches aimed at facilitating housing delivery and providing developer financing support. It may take substantial time for them to reverse home sales momentum. For the year, we expect property sales to fall 5%-8%, after a 26.7% fall in 2022. As sales remain very weak, more supportive measures may be needed to further stimulate purchases. A recovery in sales is crucial to stabilizing developer credit profiles before as well as after debt restructurings.

Support measures and slowing rate hikes may improve offshore funding access. While global central banks are likely to keep raising rates in the near term, the declining magnitude of coming hikes will make funding conditions less volatile than in 2022. This, plus supportive measures by the Chinese government, could improve investor sentiment and pave the way to better funding access for corporates. That said, such access could bifurcate further in 2023, given new rules from the National Development Reform Commission to tighten offshore debt issuance by issuers with weaker credit quality.

India

Benign Operating Outlook, Onshore Funding Mitigate Interest Rate And Currency Volatility

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Key Takeaways

- We expect resilient operating performance for most Indian corporates and infrastructure companies, with generally manageable debt loads. Declining input costs and a reversal in working capital will help improve credit quality, especially in commodity sectors.
- We forecast Indian airports to continue their strong recovery, and the regulatory framework to normalize for utilities; while renewables will need to manage execution risks associated with aggressive capex.
- A sharp rise in dollar funding costs, gradually increasing domestic interest rates, and currency volatility pose external risks to Indian corporates.

In the regulated utilities sector, we forecast healthy power unit demand growth of between 5%-7% a year. This follows a strong industrial recovery, higher government spending for infrastructure, and increasing corporate capex. We expect Indian regulators will maintain a strong regulatory framework, with full cost pass through for regulated utilities, when they conduct their 2024 review of tariffs for the next five-year period.

For most rated power utilities in India, the ratio of debt to EBITDA will remain elevated at about 5x. This is because of high growth and transition capex--with a leverage ratio of 75:25. The renewables sector will continue to attract significant private sector investments--both in equity and debt. We expect leverage to remain elevated for Indian renewable players with ongoing capex, leading to thin EBITDA interest coverage of about 1.5x and a ratio of debt to EBITDA of above 6x.

The government's Late Payment Surcharge Scheme of 2022 will likely provide temporary relief to generators and transmission companies as many state distribution companies, or discoms, have started to clear their overdue payments. However, the surcharge scheme does not resolve the structural weaknesses of the state discoms. These discoms have weak financial health, and face rising power and interest costs. They are, however, unable to raise tariffs because of socio-political issues. This is despite high aggregate technical and commercial losses of more than 20%.

Robust domestic passenger traffic and a sharp recovery in the volume of international passengers will support the performance of Indian airports. We forecast domestic passenger volumes to reach pre-COVID level by March 2023. International passenger traffic will recover to pre-COVID level by March 2024--a year ahead of our earlier expectations. Non-aero revenues will also bounce back, leading to stronger cash flows for rated airports. Capex needs are largely tied up, providing stability and upside to credit profiles.

The credit quality of Indian corporates continues to derive support from the widescale deleveraging across companies during fiscal years 2021 and 2022. This has helped companies easily mitigate the effect of rising interest rates and inflation over the past few quarters. Large capital spending, such as the 5G telecom auctions, was neutral to the credit profile of the rated entities in the sector.

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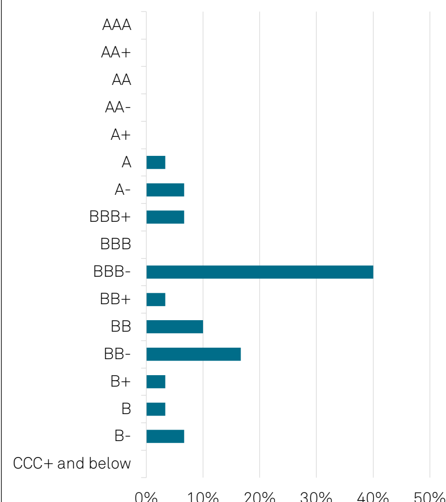

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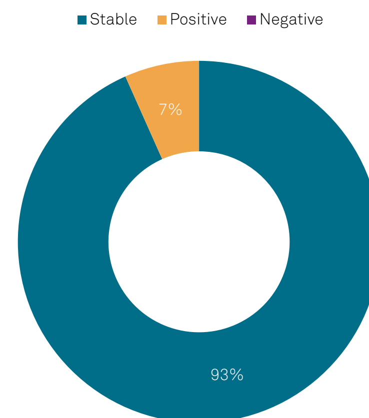

Source: S&P Global Ratings.

In fiscal 2024, we expect deleveraging to resume, benefitting from continued earnings growth, easing in input costs and a reversal in working capital. On average, the EBITDA of our rated corporate portfolio will likely grow about 12%. We anticipate capex will generally remain largely flat year on year. Capex has picked up in select sectors, notably commodities and telecoms. However, these sectors benefit from a favorable operating outlook and derive support from increased operational cash flow.

Indian infrastructure entities are more exposed to currency risk than corporate entities. Renewable players face more currency risk, with higher capex spending and greater reliance on dollar debt. Rated airports have largely raised sufficient funds to meet ongoing capex and have limited refinancing needs over the next 12 to 24 months. Regulated utilities will benefit from a cost pass through mechanism (including hedging costs and currency movement), protecting their cash flows.

Indian corporates generally maintain adequate liquidity, with onshore funding access offsetting the absence of offshore funding. Bank liquidity remains healthy and funding costs are still competitive as policy rates have yet to fully flow through to corporate borrowers. We expect a gradual increase in domestic lending rates; however, liquidity should remain adequate in 2023. High borrowing costs and limited issuances have almost completely stalled dollar bond funding. The absence of large debt maturities (with the exception of one 'B-' rated issuer) and generally manageable capex have also helped corporate liquidity. Adani Group entities--rated and unrated--have significant growth ambitions. They will need an ongoing supply of equity and debt capital. The recent allegations may hurt the group's ability to raise fresh equity or to borrow, particularly in U.S. dollar public bond markets. The cost of capital could also rise due to an additional risk premium for the Adani Group entities. Current market conditions and the sharp rise in U.S. interest rates have already severely limited issuance of U.S. dollar debt for all Indian companies, not just for Adani Group. Dollar bonds have been important for our rated entities--as the biggest source of funds--in their capital structure.

Indonesia

Moderate Refinancing Requirements A Saving Grace

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Key Takeaways

- Persistent inflation and rising interest rates are likely to keep a lid on revenue and profit growth potential for Indonesian companies in 2023. Normalizing commodity prices will limit further potential upside for commodity producers.
- Rating trajectories are more stable than a year ago. Liquidity and refinancing risk have eased for some issuers previously facing 2023 maturities following a slew of restructuring or refinancing transactions; for others, credit quality has stabilized at lower rating levels.
- Funding channels for foreign capital markets are likely to remain selective throughout 2023. But annual refinancing requirements are moderate through to 2025 and often limited to better capitalized or systematically important state-owned companies.

Inflation and rising interest rates are likely to bite more in 2023 than in 2022 for the Indonesian consumer and the domestic corporate sector. Most of the recovery in consumer confidence and spending following COVID disruptions occurred in the first half of 2022. This recovery petered out through the second half of 2022 and is unlikely to recur in 2023. Most consumer-focused indicators from Bank Indonesia show slowing growth momentum for 2023 as consumers face the full-year effect of inflation, reduced petrol subsidies, and higher interest rates on mortgages. We also believe consumer-related companies (light manufacturing, consumer products, food, autos, telecoms, and retail) will seek to raise prices more aggressively to recoup some of the margin pressure of 2022, even if it comes at the expense of growth. S&P Global Economics anticipates consumer price inflation peaking at about 5% in 2023. That could potentially slow a meaningful increase in volume and consumption.

Revenues and profit growth at rated Indonesian companies are likely to decelerate sharply to low single-digit levels. This compares with average growth of about 13% in 2022. For consumer sectors, most of the COVID-related recovery took place in the first half of 2022. Inflation is likely to curb spending power, reducing volume growth compared with 2022. Unlike the widespread increase in 2022, we project most commodity prices to be off their 2022 highs. This means commodity producers will have to increase production to boost revenues and cash flow. Real estate developers face another sluggish year because of higher mortgage rate expectations, and the expiry of the VAT discount scheme in 2022. And ahead of Indonesia's election in February 2024, consumers may also curb their spending on big-ticket items such as autos, real estate, or discretionary goods.

The rating trajectories for companies are much more stable than a year ago. All but one rated entity are on stable outlook, with one on positive outlook. That outlook distribution is a first in nearly a decade--a decade in which Indonesian companies often had the highest negative rating bias in the region. This distribution is largely due to stabilizing credit profiles at lower rating levels (such as for animal feed producer PT Japfa Comfeed). Or because of rating withdrawals of entities previously on negative outlook that restructured their debts or bought back bonds. For the rest, the following attributes generally underpin the stable outlook: reduced imminent liquidity issues,

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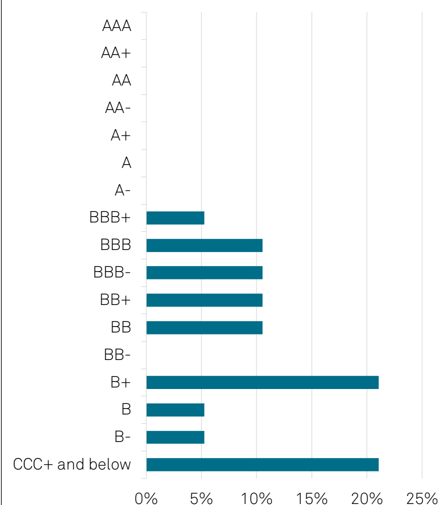

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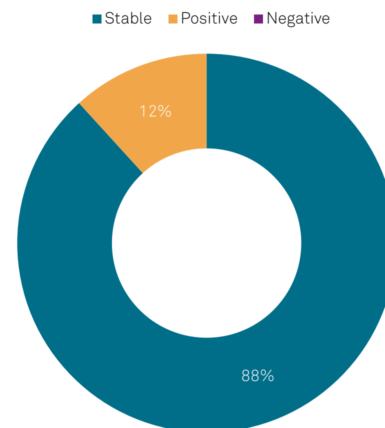

Source: S&P Global Ratings.

broad revenue and profit stability versus 2022, moderate margin pressure, slowing spending and flat debt. And for SOEs, it's tied to the underlying stable outlook on the sovereign rating.

Fewer maturing bonds in 2023 and 2024 should mean less near-term pressure to refinance. We estimate that a manageable US$3.0 billion-US$3.5 billion in foreign currency bonds issued by Indonesian corporate issuers will mature annually in 2023, 2024 and 2025. Most of these amounts emanate from better capitalized or more systemically important SOEs, which we believe will maintain good access to capital markets. Numerous smaller issuers previously facing 2023 and 2024 debt maturities have either restructured, renegotiated or refinanced their debt in 2022, and pushed the new maturities to beyond 2026. This provides relief, because we still expect capital markets to stay very selective in 2023; any funding windows for speculative-grade companies are likely to be very short and residual funding uncertain ahead of the 2024 elections. Funding conditions in the domestic bank market are somewhat more accommodating, albeit several hundred basis points more expensive, than 12 months ago. Higher funding costs could, however, create more downside, defaults or restructuring for working capital-intensive sectors that rely on short-term funding. Such sectors include retailing, construction, and trading. Debt transactions and restructuring are also likely at some of the more leveraged SOEs.

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Indonesia Commodities Sector Outlook:

The net outlook bias for Indonesian commodities remains positive. This positive trend has contributed to several upward rating actions in recent years. Positive rating actions invariably outweighed negative actions in 2021 and 2022. That said, the upward rating momentum slowed in the fourth quarter of 2022. Our ratings already reflected the moderation in prices and the meaningful balance sheet deleveraging stemming from healthy cash flows.

Lower commodity prices and persistently high costs are likely to erode margins after healthy profits in 2021 and 2022. Buoyant oil and metal prices are moderating as costs increase. We expect market and pricing conditions to generally remain supportive in 2023. Commodity prices remain higher than previous troughs. This is despite the price of oil and most metals falling in 2022, and a weakening economic outlook. However, risks are anchored firmly to the downside. The threat of a global economic recession, the Russia-Ukraine conflict, and China's tentative reopening could stoke market uncertainty and further price volatility.

Credit buffer is generally good for the sector; most issuers with above average-cost positions can withstand further price pressure before testing our downside credit thresholds. As a result, we expect issuers in this sector to yield healthy profits and cash flows, which will support shareholder returns, growth capex, and acquisitions. This comes after commodity prices remained largely buoyant in 2022, before moderating in the second half. This mostly confirms our previous assumptions of lower prices in 2023 from record levels in 2021 and 2022.

Funding conditions for U.S. dollar bond issuance for high-yield issuers will remain tight, while ESG constraints are likely to restrict access to capital. We expect this market trend to particularly hold true for brown sectors such as coal. Still, refinancing needs over the next 12 months should be manageable. We anticipate issuers will tap domestic banking relationships to meet near-term maturities. Where conditions allow, the need to raise significant amounts of capital to fund growth projects, and a need to diversify funding sources and secure funding with greater tenor will continue to spur appetite for U.S. dollar-debt issuance.

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Indonesia Property Sector Outlook:

Weaker buyer sentiment has muted the momentum of Indonesian residential sales. We forecast a flat to low single-digit decline in residential marketing sales in 2023, compared with about 5% growth in 2022. Inflation, higher mortgage rates, and a lack of new incentive schemes such as the VAT discount in 2021 and 2022, will constrain consumer sentiment. Property developers will continue to target end-user demand, especially toward affordable landed housing projects. We expect industrial land sales to improve as foreign buyers return and rental income from retail commercial properties recovers. This will help to make up for soft residential home sales.

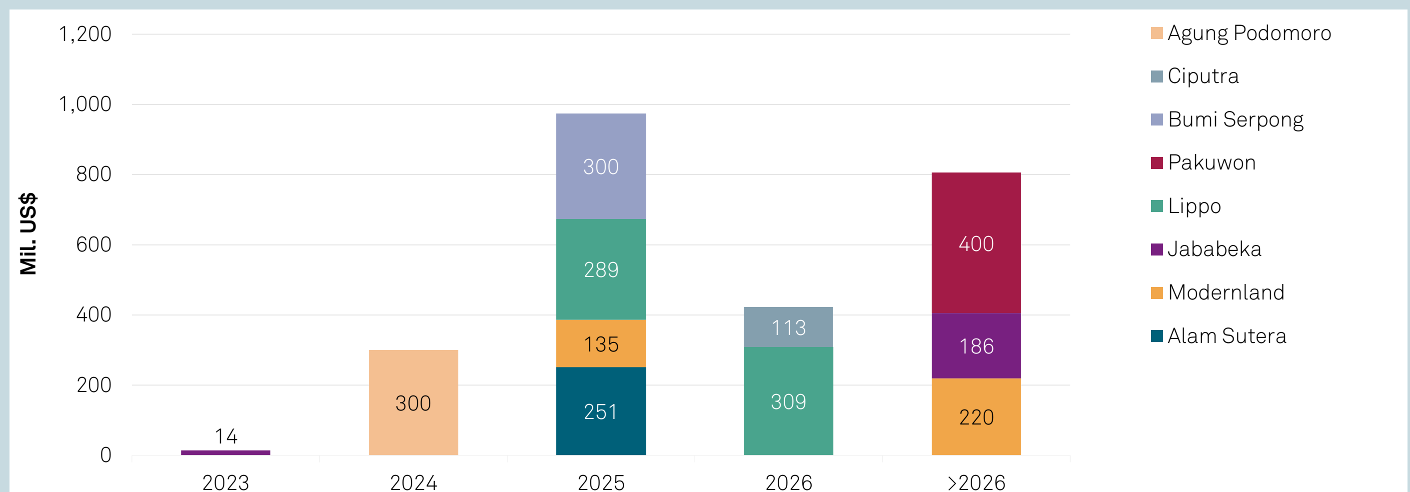
The credit quality of Indonesia developers is unlikely to improve. Developers have limited capacity to deleverage because of sluggish generation of free operation cash flow. This stems from slower sales and cash collection, and higher construction costs. Furthermore, as developers continue to refinance their U.S. dollar debt obligations with domestic bank loans, they will erode their cash position because of the amortization feature of this arrangement.

We project absolute debt to remain largely flat for Indonesia developers as we expect limited debt-funded expansion. We forecast aggregate capex to contract by 5% or remain flat compared with 2022. The sector is likely to take a cautious approach on capital spending in the face of rising construction costs and the looming election.

The funding environment for lower-rated Indonesian developers remains fraught. After a round of multiple debt renegotiations, and refinancing or extensions, Indonesian developers have limited refinancing needs over the next 12 months. However, refinancing activity will increase heading into 2024 to address the looming maturity wall in 2025. This may heighten the sector's refinancing risk again. This is especially the case for entities in the 'B' category and below if their access to offshore funding remains constrained. Therefore, the likelihood of developers conducting debt market transactions below par well ahead of actual maturity dates remains relatively high. As the sizable bank loans granted over the past 12 months indicate, developers have turned to domestic banks for refinancing. However, domestics banks are unlikely to fully satisfy the sector's refinancing needs.

Modest Refinancing Needs In 2023 And 2024

But maturity wall looming in 2025



Note: Data only comprises maturing foreign-currency bonds, converted into U.S dollars, and excludes bonds refinanced with bank loans. Mil.--Million.
Source: S&P Global Ratings computations from company financial statements as of February 05, 2023.

Japan

Tentative Steps In The Credit Recovery

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Key Takeaways

- Rising costs and a slowing global economy will stall improvement in credit quality for Japan's corporate sector.
- However, company efforts and momentum in the sectors that benefit from the rise in commodity prices suggest overall credit recovery will continue.
- We expect financials to remain sound as asset sales and hybrid issuance offset continuing growth in investment. Less creditworthy corporations may struggle with high repayment costs for foreign currency denominated bonds; access to overseas financing may get tougher.
- Rating outlooks have a more negative bias (23%) than positive (13%).

Credit improvement continues amid tough business conditions. The credit quality of the Japanese corporations we rate is likely to improve, although at a slower pace. As of mid-January 2023, 64% of the outlooks on long-term issuer credit ratings on Japanese corporations were stable. The percentage of positive outlooks has increased to 13% from 2% a year earlier. We see credit improvement in such sectors as oil, steel, and general trading and investment companies, backed by high commodity prices. We have also seen credit improvement in companies that have made solid progress in business restructuring, such as Hitachi Ltd. and Olympus Corp. However, factors that could threaten the credit quality of Japanese corporations in the next year or so include rising costs fueled by soaring raw material prices and a global slowdown. Because Japanese customers are highly sensitive to pricing, many corporations haven't sufficiently passed on cost increases stemming from high raw material and fuel prices, which in turn is squeezing profitability. Furthermore, a slowdown in the U.S. and Europe could dampen demand for products and services of export-led companies. This would drag down the performance of the auto, electronics, and machinery industries.

Acquisitions and growth investments might increase financial pressure. The burden of growth investments is a risk factor for credit quality of Japanese corporations, especially because their business performance is improving at a slowing pace. This is true even if the investment is not in cash but in equity. If Japanese corporates are to stay competitive in global markets then it is crucial to make growth investments in decarbonization and other advanced technologies, expand business scale, and enter new markets. In February 2023, Takeda Pharmaceutical Co. Ltd. announced it had completed its acquisition of Nimbus Lakshmi for US$4 billion. This is to expand its pipeline in focused therapeutic areas. Sharp Corp. reconsolidated its large liquid crystal display panel business in June 2022 through an equity deal. This threatens earnings stability and creditworthiness, in our view. And in May 2022, to expand its renewables business, Toyota Tsusho Corp. spent Japanese yen (¥) 18.5 billion to make Eurus Energy Holdings Corp. a fully owned subsidiary.

Defenses will be tested. The Japanese corporations we rate are generally resilient to severe external conditions. We still attribute investment-grade ratings ('BBB-' or higher) to about 90% of them, despite recent turbulence. Even if an economic downturn threatens business performance, we expect a high share of them to adhere

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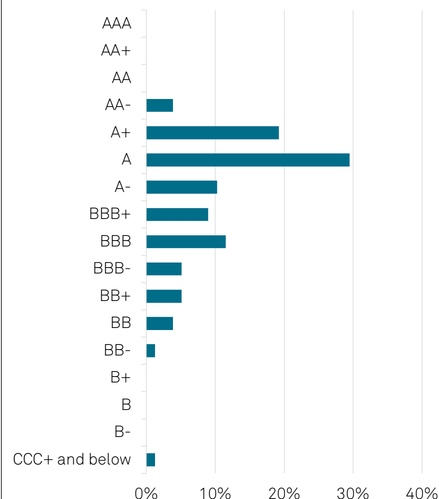

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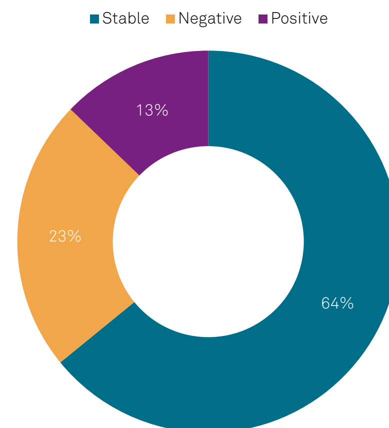

Source: S&P Global Ratings.

to disciplined financial management and take some sort of mitigating action. This could include cutting costs and cash outflows, selling assets, or financing through the issuance of hybrid securities. In late 2022, Tokyo Gas Co. Ltd. and Jera Co. Inc. issued new hybrid bonds and loans to alleviate financial pressure. Company efforts to divest less competitive businesses, as seen in Hitachi and Olympus, will fortify financial health.

Financial metrics to recover moderately in 2023. In our base case, we expect the aggregated debt to EBITDA of rated issuers in Japan to moderately recover to about 2.1x in 2023 from 2.3x a year earlier. This metric was 1.8x in 2019 before the pandemic. With a gradual recovery in consumption and factory production, we assume aggregate EBITDA will rise by 5%-7% in 2023 compared with 2022. In our view, as seen in the technologies sector, strategic growth investment for M&A and group reorganizations will likely remain high. However, we anticipate rated Japanese issuers will manage the financial strain. Therefore, in 2023 we project only a moderate increase (1%-3%) in aggregated debt.

Refinancing getting tougher and costlier. Most rated Japanese corporates maintain an ample cash balance. Their relationships with domestic banks are also generally longstanding and well diversified. We don't expect major obstacles to refinancing yen-denominated bank loans because Japanese banks have kept their balance sheets relatively sound. That said, we believe companies should accept higher interest expenses on their future financing. Companies whose performance has worsened or those that shoulder a heavy financial burden may face difficulty in refinancing transactions. Japanese corporations will be repaying a large amount of about US$40 billion of U.S. dollar-denominated bonds due in 2023. Also, we expect hybrid issuance amounts are likely to bounce back to elevated levels in 2023 because the arrival of the first call date of existing hybrids creates strong refinancing demand.

Autos: Solid Financials Will Continue Despite Prolonged Earnings Pressure

The earnings of Japanese automakers will remain subdued over the next 24 months. We anticipate semiconductor supply chain issues to continue to constrain auto production. We expect global auto sales will recover only moderately in 2023, with annual growth of 3%-5%. We now believe a full recovery of global vehicle sales will occur after 2024. Global auto sales dipped in 2022, following 4.6% growth in 2021. In addition, raw material, labor and freight costs will remain high over the next one to two years. Amid tough conditions, Japanese original equipment manufacturers (OEMs) have been steadily launching new models in key markets such as the U.S. and China. The improvement in product competitiveness resulted in higher average selling prices and smaller sales incentives. The weaker yen is also supporting earnings. Despite persistent pressure, we expect Japanese auto OEMs' average EBITDA margin will be around 7%-8 % over the next one to two years, staying at similar level to fiscal 2021 (8.0%)

We expect Japanese auto OEMs will maintain solid financials. The financial burden is likely to increase due to the large spending to implement electrification strategies. Toyota Motor Corp. has announced a nine-year investment plan to spend ¥4 trillion for battery EVs with a target to expand its battery EV sales to 3.5 million units by 2030. Nissan Motor Co. Ltd. is also willing to invest about ¥2 trillion over five years, aiming at 50% electrification model mix by fiscal 2030. However, we expect those investment plans will unlikely hurt their financial health given their financial discipline and their current net cash position at auto operation (about ¥8 trillion for Toyota, about ¥2 trillion for Honda Motor Co. Ltd., about ¥1 trillion for Nissan). In addition, Japanese OEMs actively make use of their hybrid technologies and alliance partnership, which lessens financial burden compared with global peers.

As at the end of January 2023, more than 80% of Japanese automakers/auto suppliers have a stable outlook with adequate rating head room. However, key risks include supply chain issue, cost inflation, global economic slowdown. We also believe accelerated battery EV growth is a risk factor for Japanese auto makers. This is because that could increase downward pressure on their competitive position in the global market. In addition, financial pressure could further increase because of acceleration of strategic investment for electrification.

Electronics: Credit Quality Hinges On Financial Discipline

We expect global IT spending to remain resilient in 2023, growing more than 3%, still slightly outpacing S&P Global Ratings' global GDP growth forecast of 2.2%. The growth is supported by increasing demand for cloud services and recurring software sales. This offsets weak demand for hardware such as PCs and volatility in the semiconductor sector. However, we expect most Japanese electronics companies to continue to expand revenues, albeit moderately. We forecast revenue of non-memory semiconductor companies to post a low single-digit increase, likewise for IT service companies. Conversely, office equipment companies will struggle because of entrenched remote working, leading us to anticipate low-digit decline.

Amid slower growth in the global electronics sector, the Japanese electronics sector's negative rating bias has deteriorated slightly to 13% in January 2023 from 8% a year ago. Two thirds of ratings in the sector are on stable outlook as of January 16, 2023. We anticipate the sector's aggregate revenue will increase by 8%-9% in fiscal 2022, partially pushed by the weak yen, and steadily grow by 2%-3% a year after. Aggregate EBITDA in 2023 is likely to increase slightly by about 5% amid inflation of input costs and supply chain damage. The median EBITDA margin in 2022-2023 will remain flat at about 14%; it stood at 14.2% in 2021.

The majority of rated companies in the sector continue to have adequate financial headroom at the current rating because of their low leverage. We project median debt-to-EBITDA ratio in 2023 for the electronics companies in investment grade to stay below 1x. This is despite companies' aggressive capital expenditure and growth investments. However, the risk for the companies in the sector, in our opinion, is mostly about financial discipline: persistently large investments and sizable shareholder returns without mitigating measures (such as asset sales or equity issuance) would diminish financial headroom. In fact, we saw aggressive growth investment in the sector in 2022.Examples are Sharp Corp. and Rakuten Group Inc., both of which are on negative outlook, due to weaker earnings prospects in the invested business and a slashed financial buffer.

Regulated Electric And Gas Utilities: Electric Utilities Will Suffer High Fuel Prices; Gas Utilities Will Suffer Cost Of Changing Business Portfolio

Credit quality for rated Japanese companies in the sector will be negative in 2023. Of the rated Japanese utilities, 30% have negative outlooks. We expect high fuel prices to squeeze the profitability and ratings of Japanese electric utilities. We expect gas utilities' ongoing changing business portfolio to focus on unregulated business to heighten earnings volatility and elevate debt burden on them.

The rapid rise in fuel prices since 2021 and the tumbling yen have inflated costs, hurting the performance and finances of major electric utilities, known as electricity power companies (EPCOs). They import most of their fuel, such as liquefied natural gas and coal. Also, the Russia-Ukraine conflict casts uncertainty over the industry's stable procurement of energy. Major EPCOs are unable to fully pass on cost increases to customers because they've reached the maximum limit the fuel cost adjustment system allows. EPCOs can pass on fuel price fluctuations to a degree with a lag of three to five months. Major EPCOs are likely to raise prices further by amending their fee structures and working with the relevant parties to eliminate the cap on the amount of fuel cost increases they can pass on. Even so, their finances will remain under some pressure if the price hikes are not timely and sufficient.

The credit quality of major EPCOs will nevertheless find support. Their business operations continue to benefit from favorable regulations, and the government is highly likely to provide extraordinary support in times of financial stress. Also, once fuel prices and the yen settle down, the fuel cost adjustment regime will help them to substantially pass on cost increases. As such, we expect EPCOs' profits to recover accordingly in fiscal 2023 and thereafter.

Gas utilities will suffer from the cost of changing business portfolio. Their financial metrics have somewhat deteriorated due to aggressive investment in unregulated business such as domestic power businesses, and overseas renewable energy and gas upstream businesses. The rated issuers have been doing so because the domestic regulated gas market shows limited growth prospects. Also, the stability of profit and cashflow will gradually decrease because of the increasing weight of volatile unregulated business. On the other hand, gas utilities have more flexible pricing models than EPCOs. They have been able to pass on cost increases to customers almost in full.

South Korea
Screws Are Beginning To Turn

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Key Takeaways

- Slower growth, weak demand, inflation, and higher interest rates will strain the operating performance of Korean corporates in 2023.
- Semiconductors and utilities seem most at risk, given a rapid deterioration in their profitability and cash flow whereas autos and electric vehicles (EVs) and related industries could be more resilient.
- The creditworthiness of Korean companies we rate will be relatively resilient, but this will depend on the aggressiveness of financial policies.
- Some nonrated small and midsize firms (particularly in the property sector) that have limited liquidity buffers could face serious credit risks.

Credit quality of Korean corporates began to weaken in the second half of 2022, and we expect harsher conditions in 2023. Although stable outlooks account for about 87% of the portfolio, negative rating actions outnumbered positive ones in the second half of 2022. We revised down outlooks on SK Hynix Inc., LG Electronics Inc., and S-Oil Corp., and the stand-alone credit profile on Korea Gas Corp. since July 2022. Financial metrics also weakened from the third quarter, with most sectors showing deterioration in operating profits. Most notably, operating profit in the technology sector shrank, with a plunge in semiconductor profitability. The operating loss in the utilities sector also widened. Korea Electric Power Corp. (Kepco) continued to post appreciable operating losses due to high input costs and insufficient tariff hikes. Meanwhile, funding costs rose in 2022, on the back of rising policy rates and credit events, including a default by Legoland. We view higher funding costs as another strain for Korean corporates, especially those with aggressive financial policies.

The technology and utilities sectors likely face near-term strain. The semiconductors downcycle will likely continue into 2023 because of oversupply and average selling price (ASP) pressure from weak demand for PCs, smartphones, and servers. We project SK Hynix will continue to make large operating losses in the first half of 2023. This comes after it reported substantial operating losses of Korean won (KRW) 1.7 trillion in the fourth quarter of 2022. Its NAND flash business, in particular, will take longer to recover, adding to the pressure. Semiconductor companies announced capex cuts for 2023, but large inventory and tightening U.S. regulations on China will add to weakening demand.

Utilities companies also face a rapidly rising debt burden as tariff hikes fail to offset rising input costs. Kepco and Korean Gas Corporation (Kogas) have posted big rises in their debts, year to date. Kepco's reported debt rose by Korean won (KRW) 29 trillion to KRW110 trillion in the first three quarters of 2022, as it reported KRW22 trillion of operating losses during the same period. Kogas' reported debt also rose by KRW9 trillion to KRW35 trillion, due to an increase in working capital demands and mounting receivables due to weaker tariff hikes.

Despite broader weakness, autos and EV value chain corporates may prove more resilient. We believe supply-demand dynamics for the auto sector could remain relatively balanced, thanks to tight inventory levels and sizable order backlogs. Hyundai Motor and Kia are operating with a short day-sales-of-inventory time of about

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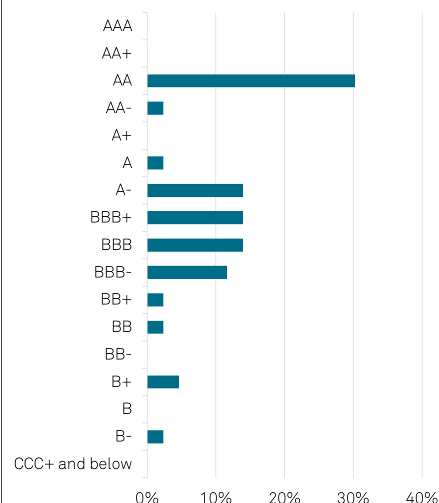

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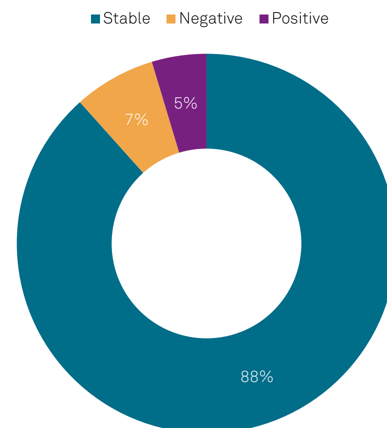

Source: S&P Global Ratings.

one month (compared with two to three months previously). This stems in part from supply constraints caused by chip shortages. The ASP has also been rising with better product mixes, which has improved profitability.

In addition, we continue to witness a structural shift toward electrification of vehicles, and revenue as well as investment growth across the EV value chain. Korean EV battery makers, such as LG Energy Solution Ltd., SK On Co. Ltd., and Samsung SDI, posted record revenues in 2022, as global EV adoption rises. EV makers are working with OEMs to increase investments in capacity to meet the growing demand. We also see many Korean conglomerates, including LG, Posco, SK group, expanding investments in key battery materials, such as cathodes, anodes, and separators.

Korean corporates are shifting their investments to the U.S. We see major conglomerates, including Samsung, Hyundai Motor group and LG group, building production facilities in the U.S. Various factors are driving this trend. These include regulatory changes that incentivize production in the U.S., political tension between China and U.S., and expectations of faster penetration of the EV market. For example, Samsung Electronics has announced a US$17 billion investment to build an advanced semiconductor plant in the state of Texas, while Hyundai Motor group is also investing US$5.5 billion to build an EV production plant in Georgia. EV battery makers such as LG Energy Solutions, SK On, and Samsung SDI are also adding capacity by engaging in several joint ventures (JVs) with OEMs.

EV Value Chain: Korean Conglomerates On The Brink Of A Battery Boom

Korean conglomerates are well placed to capture a big share of global sales of EV batteries. We estimate the market for EV batteries will grow to about US$320 billion in 2030 from US$40 billion in 2021. S&P Global Mobility assumes global EV battery demand will reach 1,918 gigawatt hours in 2026--almost six times the demand in 2021. As EV demand escalates, carmakers are facing a battery shortage, and are keen to lock in supply arrangements with producers.

Korean entities are welcome JV partners as global carmakers are keen to secure EV battery supply. EV penetration rates in the U.S. are set to rise 4x-5x by 2025, making it the fastest-growing large market. Korean conglomerates come with little geopolitical baggage and are investing heavily in the U.S. market. Among the most recent JVs, LG Energy Solution Ltd. announced a US$2.6 billion investment into building a new battery cell plant in Michigan--called Ultium Cells--via its JV with General Motors Co. Honda has also announced investments of about US$4.4 billion with LG Energy Solution for a battery-making venture in Ohio. SK On Co. Ltd. recently made public its plan to invest US$1.9 billion in a new EV battery plant in Georgia with Hyundai Motor Co. Posco Chemical Co. has signed a JV with GM (Ultium CAM) for cathode production.

We believe most corporates can absorb the steep upfront capital cost of expansion in EV sector, although this may stretch the balance sheet of some conglomerates even further. In our view, all entities will face meaningful execution risks in relation to the expansion plans.

For LG Chem Ltd. and LG Energy Solution, we view credit implications of the groups' EV-related expansions as positive for the medium to long term. That said, the effect on credit over the coming 12 to 18 months for both entities could be more neutral. The sizable expansion plans will drag on cash flow and financial metrics over the next two to three years, despite improving profitability.

For SK Innovation Co. Ltd. (including its EV battery subsidiary SK On), on the contrary, we view credit implications as negative for the coming two years. SK On's ambitious expansion will strain cash flow and financial metrics. SK On is still incurring operating losses and won't likely contribute to SK Innovation's cash flow for the next one to two years. Assuming the company manages its execution risks, we view the credit implications of the entity's EV battery expansion as neutral to positive beyond this period.

For Posco Holdings, we view the credit implications of its expansion plan as positive. It's unlikely the initial capex, while substantial, will lead to much new debt raising. The growing EV battery material business should not only boost the company's earnings but improve the diversity of these earnings too.

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