

Blackpink or BlackGold? Short KNOC notes

The recent appointment of Korean popstars Blackpink as ambassadors for the UN COP26 climate conference in November could be a harbinger of waning Republic of Korea political support for national oil company KNOC (ticker: KOROIL) in general and its BlackGold Canadian tar sand operations specifically.

KNOC completely eroded its equity base in 2020.¹ Current credit ratings and spreads on KNOC (average AA) appear to solely rest on an assumption of continued government capital injections and access to international funding.

Given the correlated nature of these assumption, any challenge to them could give rise to significant downward price movements, which could dwarf the 25 point moves in Eksportfinans bonds in 2011 (Figure 1).

KOROIL bonds trade close to the Korean sovereign. We highlight ways to short the bonds through the cash market, through CDS and through basic underweights in benchmarked portfolios. We believe the upside for shorts could be in the >25 cents on the dollar range with shorting costs around 0.5-1.5% p.a.

We see a non-zero probability of a withdrawal of government support that would effectively put bond investors at high risk of being restructured, with low recovery values. Among other things, KNOC remains a financial sinkhole for taxpayer. Further capital injections to KNOC must be approved by Parliament. Recapitalizing KNOC will not help South Korea's negotiations at COP26.

We see a non-zero probability of the company losing its historically friendly relationship with international capital.² With almost USD700mn of bond maturing in mid-April (Table 1), the company is currently in the market looking to sell bonds. The success of that bond issuance should not be a given: many ESG minded financial institutions apply exclusions for tar sands financing. Specifically, Swiss investors like UBS and Credit Suisse – appearing as the biggest lenders in KNOC hard currency bonds - may have an appetite that is disappearing even faster than the Great Aletsch Glacier.

Figure 1. Eksportfinans (NOR) lost its implicit government guarantee in late 2011. The bonds were immediately downgraded by Moodys from Aa3 to Ba1 (junk). Bond prices fell by 25 points, despite the company being a going concern.



¹ "The Company has experienced complete equity erosion in 2020 due to a large net loss resulting primarily from significant declines in the prices of crude oil." Company source, 23 Mar 2021.

² We argued around this in "[Tar sand new issue alert: Korea National Oil Corporation](#)", 24 Mar 2021. Flash new issue update for 29 March announcement further below.

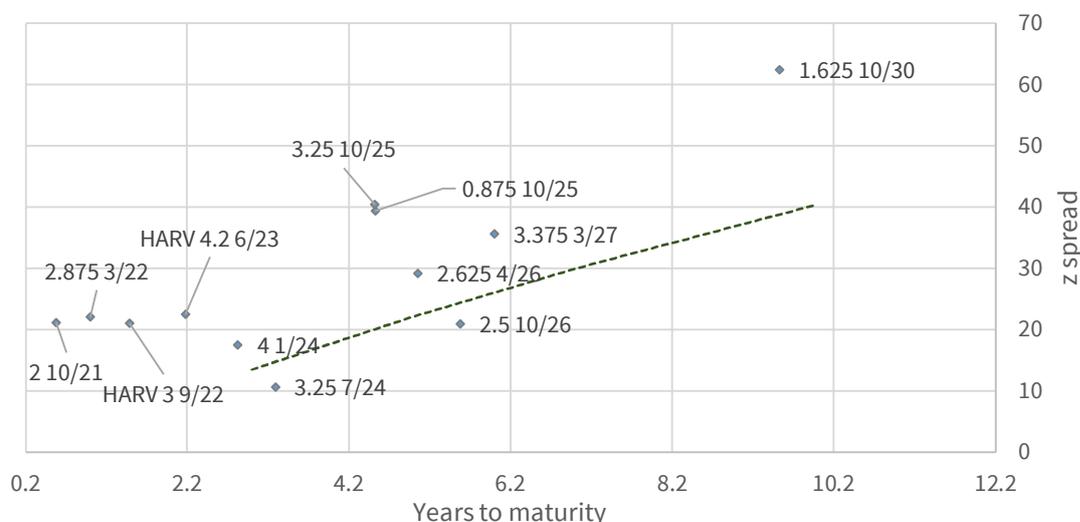
KNOC bonds and shorting

KOROIL has total debt of USD12bn outstanding with the majority of this (53%) in USD, (17%) in KRW, and (8.5%/8.5%) in CHF/EUR. For trading purposes, it is only the USD debt that is relevant. Roughly USD1bn of bonds are set to mature before COP26, with two maturities on 14 April this year already. For practical purposes, note that KOROIL bonds are indicated both under the “Govt” as well as “Corp” suffixes on the Bloomberg terminal. KOROIL Corp gives the list of what we assume are the legacy bonds of the Harvest purchases – as these bonds under NAME mnemonic are given as “HARVEST OPERATIONS CORP”.

Table 1. Large KOROIL bond issues. “HARV” (red highlights) indicates bonds trading under the Harvest brand. Pricing date: 26 March 2021. Source: Bloomberg, Anthropocene Fixed Income Institute.

USD						
Bond name	Coupon	Size (USDmn)	Maturity	TTM	z-sprd	Yield
1.625 10/30	1.625	300	2030-10-05		9.5	62
3.375 3/27	3.375	500	2027-03-27		6.0	36
2.5 10/26	2.5	650	2026-10-24		5.6	21
2.625 4/26	2.625	500	2026-04-14		5.0	29
0.875 10/25	0.875	400	2025-10-05		4.5	39
3.25 10/25	3.25	600	2025-10-01		4.5	40
3.25 7/24	3.25	550	2024-07-10		3.3	11
4 1/24	4	500	2024-01-23		2.8	18
HARV 4.2 6/23	4.2	398	2023-06-01		2.2	23
HARV 3 9/22	3	485	2022-09-21		1.5	21
2.875 3/22	2.875	500	2022-03-27		1.0	22
2 10/21	2	350	2021-10-24		0.6	21
2.125 4/21	2.125	500	2021-04-14		0.0	-35
HARV 2.33 4/21	2.33	196	2021-04-14		0.0	-198
CHF						
Bond name	Coupon	Size (USDmn)	Maturity	TTM	z-sprd	Yield
0.2625 7/27	0.2625	212	2027-07-30		6.3	23
0.875 4/25	0.875	212	2025-04-21		4.1	21
0 10/24	0	318	2024-10-04		3.5	22
0.373 6/23	0.373	530	2023-06-01		2.2	19

Figure 2. KNOC/KOROIL USD bond curve, excluding near-term maturities, and Korea sovereign CDS curve (dashed lines). Pricing date: 26 March 2021. Source: Bloomberg, Anthropocene Fixed Income Institute.



We recognize the technical issues in shorting an issuer such as KOROIL, but still believe it would be possible to achieve for savvy investors:

- **Repo.** Given the high rating of the company and the relatively large amounts in which the USD bonds have been issued, we believe the repo market could potentially work for running shorts. Specifically, with UBS and CS holding \$200mn and \$110mn of KOROIL bonds respectively and given those banks' prevalence in prime-brokerage activities, we would expect a potential to access bond borrows through those sizable positions.
- **CDS.** Although there appears to be no CDS traded on the company today, we believe it would be possible to request trading focused dealers to provide CDS offers. For example, JPMorgan, Citigroup and Bank of America all have active CDS trading operations, open credit risk lines on KNOC, should be expected to provide liquidity and have cash bonds and Korea CDS as hedging instruments. The contract is already pre-programmed in Bloomberg, KOROIL CDS. We think there could be potential for flow there: KOROIL CDS could become a very attractive spread-for-rating sell protection trade for those who do not subscribe to the discussion above.

Having said that, the easiest "short" trade will naturally be:

- **Benchmark underweights.** KOROIL is constituent of many bond indices. As can be deduced from Table 1, there are at least 8 bonds that have been issued in benchmark-size and with both REGS and 144a tranches. The most natural way to "short" the bonds for benchmarked investors is obviously to go underweight vs the index. Indeed, it is hard to see any ESG minded investor being happy with having exposure to the name even through passive, index-tracking guidelines.

Flash new issue update

IPT for the new issues announced on 29 March 2021 were 5y+80 area and 10y+100area, suggesting z-spreads around z+70 and z+97. Especially the 5y looks cheap to the current curve, with the 2.625 04/26 (almost perfectly maturity matched) trading at z+29. It is clear that the banks are really looking to do a teaser rate in the IPT and we would expect these to shrink under normal circumstances. However, it is also possible that these higher rates indicate a willingness to pay up for getting access to capital – it is after all a company with zero equity and a some significant carbon liabilities.

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