

**ASIA-PACIFIC  
CREDIT STRATEGY**  
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**AUTHOR**

Brenda Solis Gonzalez  
[Brenda.Solis@moodys.com](mailto:Brenda.Solis@moodys.com)  
Head of Regional Growth & Analytics  
Asia-Pacific and Middle East

Katrina Ell  
[Katrina.Ell@moodys.com](mailto:Katrina.Ell@moodys.com)  
Head of Asia-Pacific Economics

Wei Jian Lim  
Research Associate  
[WeiJian.Lim@moodys.com](mailto:WeiJian.Lim@moodys.com)  
Regional Growth & Analytics Asia-Pacific and Middle East

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**Australia Credit Review & Outlook**

## Credit Risk Divergence: Large Firms' Stability vs. Small Firms' Vulnerability

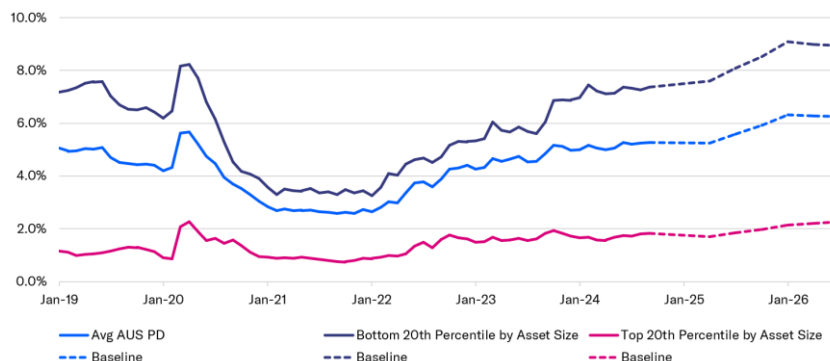
Heightened credit pressures for smaller firms amid liquidity constraints.

**Key Take-Aways:**

- The Australian economy has struggled under restrictive monetary policies, initially impacting households but now affecting businesses, with unemployment expected to rise in 2025.
- Corporate credit risk in Australia remained elevated in 2024, nearing pandemic peak levels, with smaller firms facing the highest risk due to limited access to capital and aggressive interest rate hikes by the RBA.
- Credit risk varies by firm size and sector, with capital-intensive, commodity price-sensitive, and direct consumer-facing sectors facing persistent vulnerabilities.
- Moody's EDF-X Early Warning System has flagged 30% of listed companies in Australia and New Zealand as high or severe risk, highlighting the need for proactive monitoring.
- Credit risk is expected to remain elevated through 2025 and into 2026, with firm size and sectoral exposure continuing to shape the divergent credit outlook in Australia.

**FIGURE 1** Credit risk for publicly-listed continues to deteriorate. The divergence between small and large firms has magnified in a higher-for-longer rate environment.

Average one-year probability of default (PD), monthly



Data source: Moody's EDF-X platform, October 2024

### Economic Pressures and Credit Risk: The Size Factor in Australian Public Companies

Corporate credit risk among Australian publicly-listed companies has worsened since 2022 and remains elevated in 2024, nearing the peak levels observed during the pandemic. Factors such as high interest rates, tight financing conditions, consumer spending wariness, sluggish regional growth - particularly in China- and geopolitical uncertainties have all contributed to squeezing profit margins and escalating corporate credit risk levels. The Australian economy has struggled under the weight of successive and aggressive interest rate hikes. The Reserve Bank of Australia (RBA) began its tightening cycle in May 2022, lifting the cash rate from a record low of 0.1% to 4.35% in November 2023. Consumer sentiment has been weak for over two and a half years as household budgets have been squeezed, particularly for middle-to-lower income households. Conversely, business confidence is hovering around its lowest level in 11 years as external administration filings climb and the labor market keeps cooling.

Our forecasts indicate that corporate credit risk will remain elevated throughout 2025, specially for smaller firms. Figure 1 shows the historical and projected average probability of default (PD)<sup>1</sup> for three segments of the corporate credit market: all Australian public firms (1,149 firms), the top 20<sup>th</sup> percentile by asset size (230 firms), and the bottom 20<sup>th</sup> percentile<sup>2</sup> by asset size (230 firms).<sup>3</sup> By the end of the first half of 2024, the average PD for Australian public companies rose to 5.3%, up from 5.0% in December 2023, nearing the 5.7% peak observed during the 2020 pandemic. Larger firms remained relatively stable, with the top 20<sup>th</sup> percentile maintaining an average PD of 1.7% since early 2023. In contrast, the bottom 20<sup>th</sup> percentile saw an increase from 6.9% in December 2023 to 7.4% by mid-2024.

Clearly, a firm's size is correlated to its credit risk. Larger companies often benefit from easier access to deep and liquid pools of capital. Additionally, the removal of pandemic-era support measures and the resumption of enforcement actions on unpaid taxes have further strained smaller companies. With restrictive monetary policies expected to remain in place longer than anticipated, this advantage for larger firms becomes even more significant. This dynamic is driving a growing divergence in average credit risk across the three corporate market segments illustrated in Figure 1.

Our baseline projections indicate that corporate credit risks will remain high. We derive the forecasts by conditioning the PD on Moody's Analytics baseline economic scenario<sup>4</sup>, which assumes a gradual economic slowdown in the Australian economy. Real GDP growth is expected to be a mere 1.0% in 2024, down from 2.0% in 2023, with interest rates staying elevated at 4.35% until early 2025. The RBA is estimated to first cut the cash rate in February 2025, and that will commence a gradual easing cycle through 2025. Lower interest rates will initially benefit the highly-leveraged household sector, easing household balance sheets and

<sup>1</sup> The average PDs shown in Exhibit 1 are not realized, historical default rates: they are forward-looking estimates of the one-year-ahead risk of a credit event. That means, for example, Moody's PD measure for all Australian public companies is predicting an average default rate of 5.1% one year from now.

<sup>2</sup> The top and bottom 20<sup>th</sup> percentile of firms by asset size are determined at each point in time, reflecting the composition of the corporate universe at that moment. As such, these percentiles represent dynamic groups that may vary across time, rather than a fixed set of companies tracked longitudinally.

<sup>3</sup> A company at the 90<sup>th</sup> percentile of asset size has a book value of assets of 2,536.5 million AUD, which is more than 50 times larger than a company at the median of all Australian public companies, with book value of assets of 43.4 million AUD. Similarly, a company at the 10<sup>th</sup> percentile of asset size has a book value of 4.7 million AUD, about 9 times smaller than the median of all Australian public companies.

<sup>4</sup> The full description of Moody's economic scenarios, as well as other alternative scenarios can be found in Moody's monthly economic release "Australia—Baseline Outlook and Alternative Scenarios." The conditional average PDs shown in Figure 1 are based on the economic scenarios in the September 2024 release.

boosting discretionary spending and labor market outcomes. We estimate that it takes around six to nine months for the full impact of one 25-basis point hike to fully manifest in the Australian economy. The neutral policy rate, estimated at 3.35%, won't be reached until early 2026, meaning that monetary policy will continue to weigh on domestic demand through next year, albeit to a lesser degree.

Looking ahead, the combination of high borrowing costs and a slowing economy is expected to worsen corporate credit risks in 2024. Under the baseline scenario, PDs will increase across all groups, exceeding pandemic levels before stabilizing at the end of 2025Q4. As the RBA gradually lowers rates starting in 2025Q1, we expect to see a gradual decrease in PDs across all three groups, as credit conditions ease, the economy stabilizes, and the benefits of lower interest rates are reflected in the household sector and labor market improvements. However, external factors like geopolitical risks and the pace of recovery in China might still pose challenges to this outlook.

### **Capital Intensive, Commodity Price Sensitive and Direct Consumer-facing Sectors Show the Highest Levels of Credit Risk**

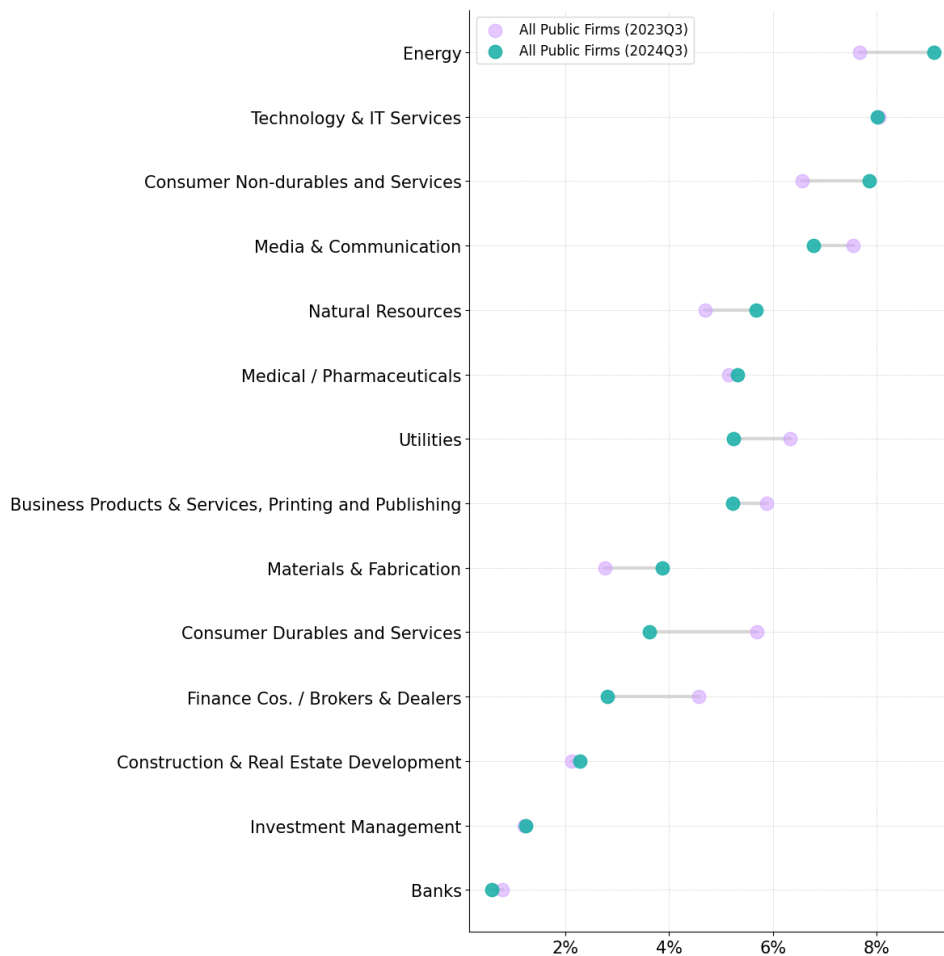
The rising levels of credit risk the Australian economy is experiencing is particularly concentrated in capital intensive and commodity sensitive sectors, with smaller firms facing greater challenges. Consumer-facing sectors are also feeling the pinch. Figures 2A and 2B provide a detailed comparison of PD levels for 2024Q3 and 2023Q3 across industry sectors, and also highlight the differences in risk between larger and smaller companies.

Figure 2A displays the PD levels for 2024Q3 and 2023Q3 across various industry sectors for all Australian public firms. The data highlights higher risk in capital-intensive sectors, those sensitive to commodity prices, and direct consumer-facing sectors. Notably, sectors like Energy, Consumer Non-durables & Services, and Natural Resources experienced the highest increase in PD, reflecting growing strain likely driven by rising input costs and demand volatility. These trends are particularly evident in the Natural Resources sector, where Australian miners have faced significant financial challenges due to falling commodity prices, rising operational costs and stricter environmental regulations. In December 2023, Panoramic Resources, a mid-tier nickel producer, entered administration, jeopardizing 300 jobs and resulting in the closure of its Savannah Mine<sup>5</sup>. Similarly, in July 2024, BHP, one of the world's largest mining companies, announced the temporary suspension of its Western Australia nickel operations, including its Nickel West and West Musgrave projects, citing falling nickel prices, rising operational costs and inflationary pressures.

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<sup>5</sup> For more details, see the Panoramic Resources case study in the EDFX Knowledge Hub: <https://edfx.com/wp-content/uploads/2024/03/20240220-Panoramic-Resources-Ltd-Case-Study.pdf>

**FIGURE 2A** Average 1-year-ahead PD by industry sector for all Australian public firms, quarterly

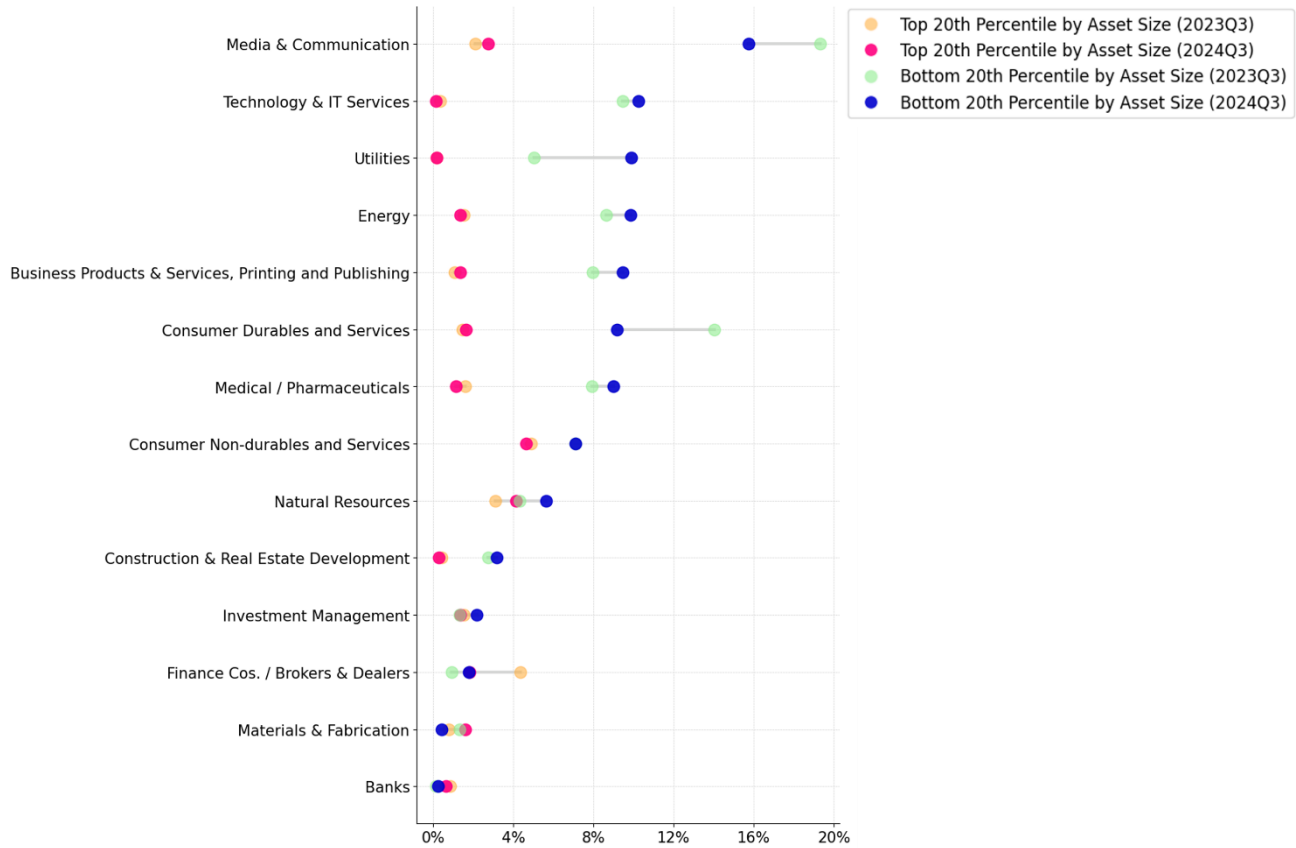


Data source: Moody's EDF-X platform, October 2024

Figure 2B further illustrates the PD levels and changes for 2024Q3 and 2023Q3 across different industry sectors, emphasizing the evident contrast in credit risk between larger and smaller firms. Excluding three sectors (Materials & Fabrication, Banks, and Finance Companies/Brokers & Dealers), the bottom 20<sup>th</sup> percentile group shows higher PDs across all 11 other sectors in 2024Q3. Additionally, over the past twelve months, more sectors in the bottom 20<sup>th</sup> percentile by asset size have experienced an increase in PD compared to those in the top 20<sup>th</sup> percentile. In the bottom 20<sup>th</sup> percentile by asset size group, 11 out of the 14 industry groups saw a year-over-year increase in their average one-year expected PD. This contrasts with the top 20<sup>th</sup> percentile by asset size, where only 5 out of 14 industry groups saw an increase in their average one-year expected PD. Among Australian public companies, the increase was observed in 7 out of 14 industry groups.

The Natural Resource sector saw an increase in credit risk across all three segments of the corporate credit market. However, the magnitude of the increase varied across the three corporate segments, with the average one-year expected PD rising by 1.0% in the top 20<sup>th</sup> percentile by asset size group and 1.3% in the bottom 20<sup>th</sup> percentile by asset size group. On average, across all Australian public firms, the sector recorded a 1.1% increase in PD. This further highlights the credit risk divergence between smaller and larger firms.

**FIGURE 2B** Average 1-year-ahead PD by industry sector for companies in the top 20<sup>th</sup> and bottom 20<sup>th</sup> percentile by asset size, quarterly



Data source: Moody's EDF-X platform, October 2024

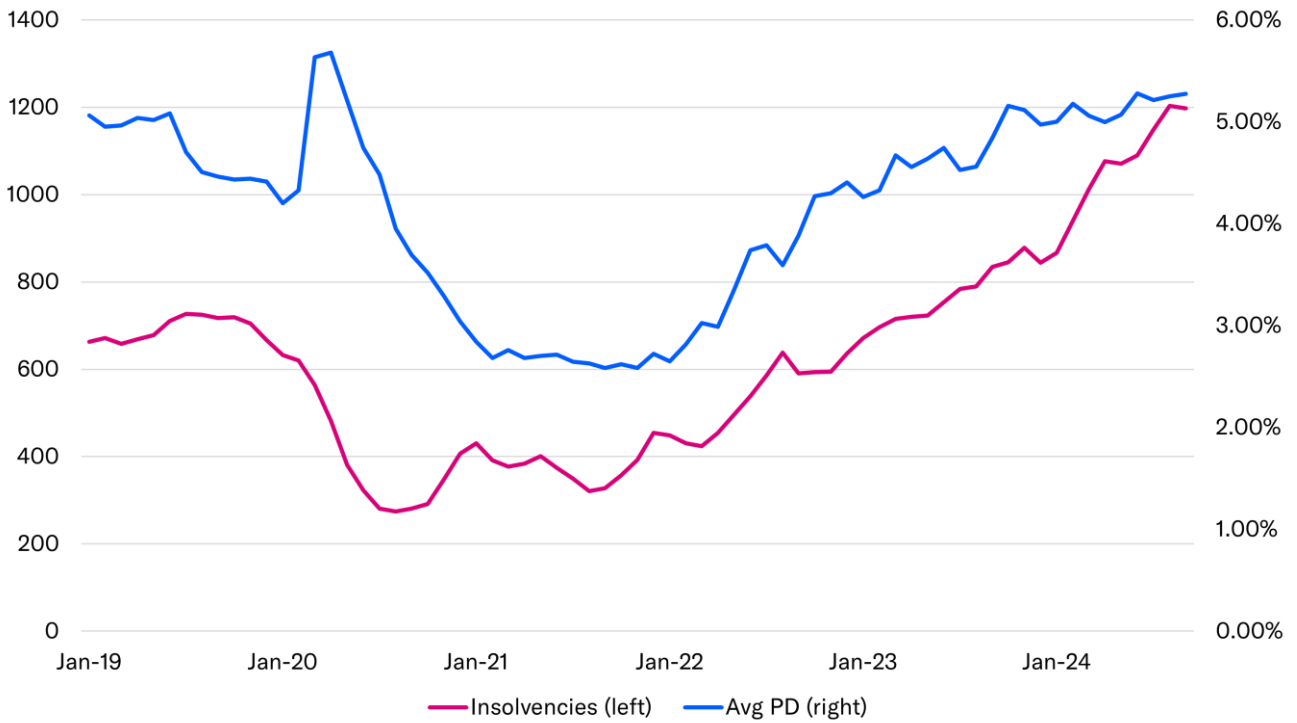
**Company Defaults Have Been on The Rise**

The deteriorating credit conditions have led to a notable increase in corporate debt defaults, as reflected in official government data. Figure 3 shows the number of first-time corporate external administrations by financial year, based on statistics from the Australian Securities and Investments Commission (ASIC) <sup>6</sup>. In FY2024, 11,053 public and private companies entered external administration or had a controller appointed for the first time. This figure marks a sharp increase compared to 4,912 companies in FY2022 and 4,235 companies in FY2021. Notably, even during the height of the 2020 pandemic, when 7,362 companies entered administration, the numbers were considerably lower. The recent levels also exceed the FY17-19 average of 7,939, underscoring the significant strain in the current environment.

<sup>6</sup> <https://asic.gov.au/regulatory-resources/find-a-document/statistics/insolvency-statistics/>

**FIGURE 3** Rising First-Time Corporate External Administrations Since FY2022, Surpassing Pandemic Levels in FY2024

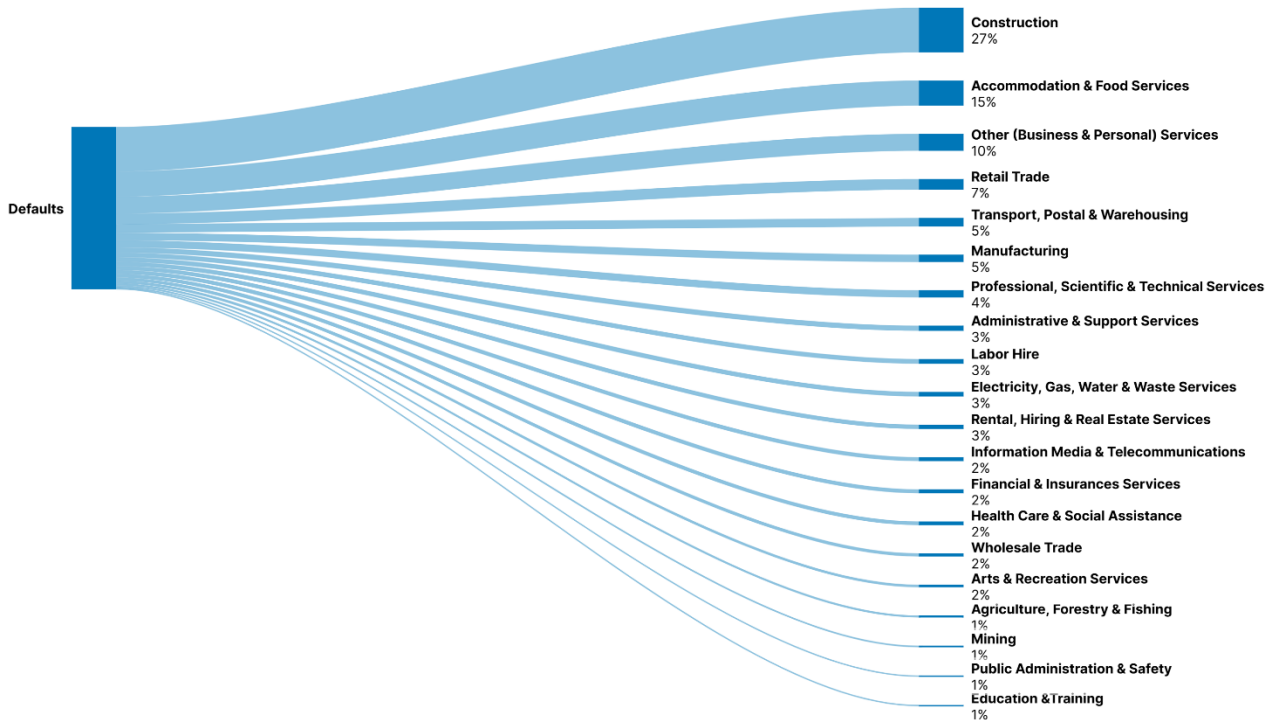
Number of First-time Corporate External Administrations in Australia



Data source: Australian Securities & Investments Commission, Moody's EDF-X platform

**FIGURE 4** Construction, capital cost-sensitive, and discretionary consumer sectors have experienced the highest number of defaults in FY2024

Counts of Australia's company defaults by industry sector for FY2024



Data source: Australian Securities & Investments Commission

In FY2024, three industry sectors – Construction, Accommodation & Food Services, and Retail Trade – faced the highest proportion of corporate defaults. Figure 4 shows the distribution of actual Australian company defaults in FY2024 by industry sector. Although these sectors only represent 4% of companies in our Australian corporate universe, their disproportionate contribution of 49% of corporate defaults highlights the severe financial distress within these sectors. Rising interest rates and economic uncertainty in recent years have posed significant challenges across sectors, particularly those with large exposure to the besieged household sector.

While these broad economic pressures affected many industries, sector-specific conditions also played a role in concentrating defaults, as seen in the construction sector. The construction sector has endured a perfect storm of challenging events in recent years. Construction material prices saw a significant price increase during the pandemic due to shortages and supply-chain related delays. The price jump has largely remained for numerous key material inputs. Making matters worse, the prevalence of fixed-term contracts meant that builders had locked in contracts at pre-pandemic material prices that still needed to be honored at the higher prices. This, coupled with ongoing labor shortages, has dented the ability of construction firms, especially smaller-to-medium size operators with more limited cash flow buffers, to stay afloat.



## Early Warning Signals Shine a Light on Risk

Given the rising credit risk for Australian companies, there is a renewed emphasis on the need to actively manage credit exposures. The natural question that arises is: how can we identify companies that are most at risk?

To address this question, we look at the data from Moody's EDF-X Early Warning System (EWS), which classifies companies as low, medium, high or severe risk based on two forward-looking early warning indicators. The first EWS indicator compares a company's forward-looking PD to an industry-specific early warning trigger level to identify companies with excessive level of risk against peers. The second EWS indicator measures the change in a company's PD-implied rating to evaluate companies own evolution of risk. Moody's research has shown that companies with PD above the trigger level, in the high or severe early warning signals, have a higher likelihood of experiencing financial distress or a negative credit event in the future. These early warning signals are useful for constructing "watch-lists" of exposures that require closer monitoring and due diligence.

Figure 5 depicts the EWS category – low, medium, high, and severe – distribution by industry sector as of October 2024. Historically, 44% of companies flagged as high or severe risk have experienced credit deterioration within a year, manifesting as downgrades, negative outlooks, or defaults.<sup>7</sup> As of October 2024, our Early Warning System has marked 30% of listed companies in Australia and New Zealand—that's 1,363 companies—as high or severe risk. The industry sector break-down of the early warning signals reveals where the pockets of weakness in corporate credit are concentrated. While cyclical industries exhibit elevated risk, sectors with unique structural challenges face the highest concentrations of vulnerability.

Comparing the early warning signals from Figure 5 with the PD levels and changes presented in Figure 2A, we observe that some industry sectors have shown an easing of credit risk over the past year for all Australian public firms. Notably, sectors such as Consumer Durables and Services, along with Media & Communication, are among these (as detailed in Figure 2A). Despite this easing, these sectors still exhibit relatively high concentrations of high/severe signals, as shown in Figure 4 driven by the continued slowdown in consumption growth among Australian households, coupled with weak global demand and persistent pressures from rising input costs.

The commodity sensitive sectors also display high concentration of high/severe companies such as Natural Resources, Energy and Utilities. Despite enjoying high commodity prices last year, these sectors face challenges from high earnings volatility and significant exposure to climate regulation. The push towards energy transition is leading to higher capital expenditures and increased debt. With climate goals and geopolitical risks continuing to drive earnings volatility, we expect high credit risk projections to persist through 2024 and beyond.

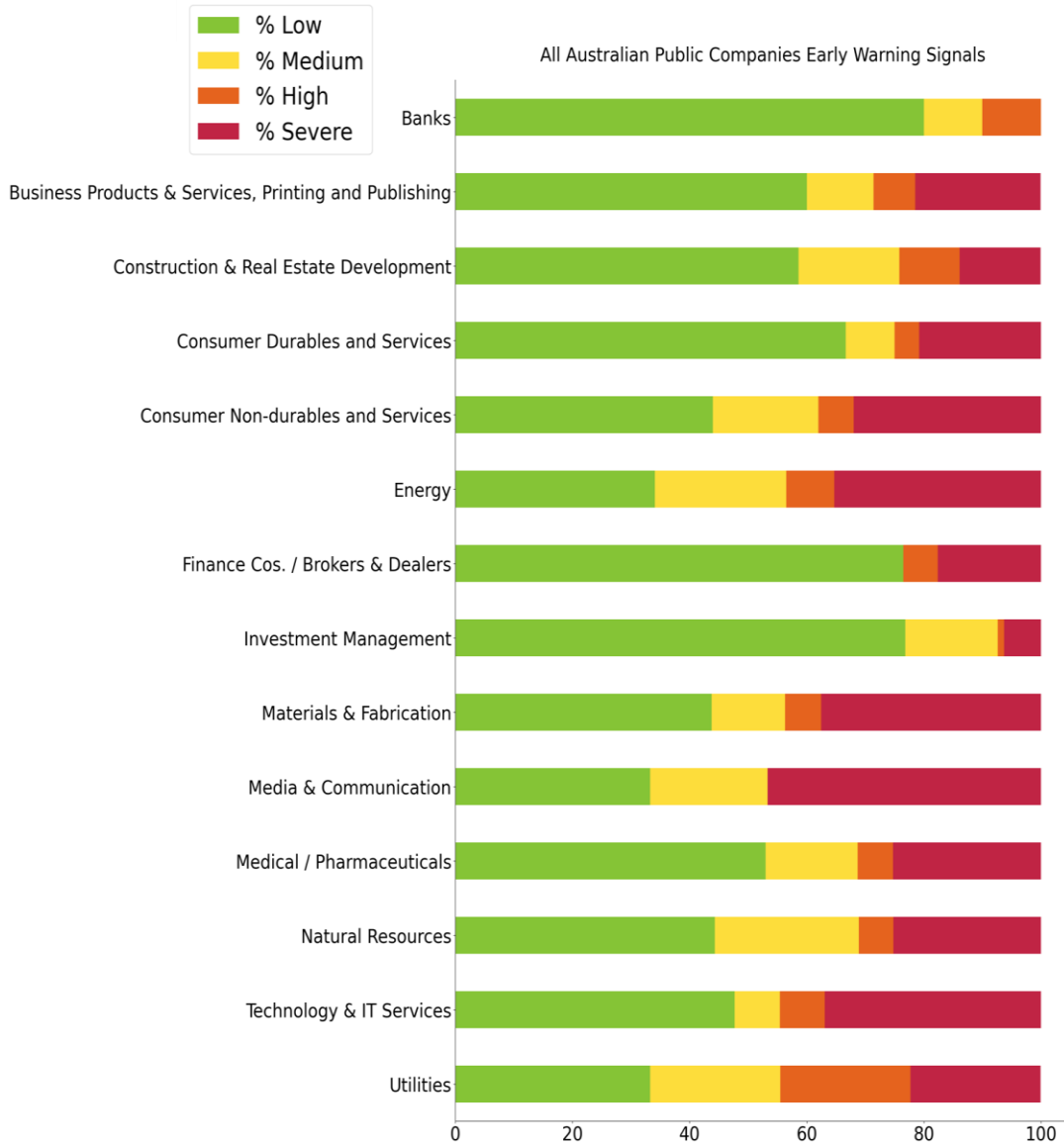
Sector-specific challenges also persist in the Construction sector. The residential construction market continues to grapple with acute undersupply in the face of soaring demand. For the construction sector, housing construction approvals continue to fall and larger scale projects are increasingly being delayed, scaled back or cancelled, as construction and funding costs remain elevated. According to the Australian Bureau of Statistics, the value of residential construction work done in Australia saw a 3.7% fall between June 2023 and June 2024. Building activity, in terms of the total number of dwellings commenced, also fell by 1.6% within the same period.

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<sup>7</sup> Hamilton, D. et al. Early Warning System. EDF-X Methodology document. Moody's Analytics, October 2022.



**FIGURE 5** Industry sector EWS signals help disentangle the signal from the noise



Data source: Moody's EDF-X platform, October 2024

## Conclusion

The Australian corporate credit landscape has experienced significant strain over the past 3 years, particularly for smaller firms. Aggressive interest rate hikes by the RBA have weighed heavily on household and corporate finances. This has led to weakened consumer sentiment, subdued business confidence, and has resulted in rising external administration filings. The higher credit risk in the Australian corporate landscape is reflected in the increase of the forward-looking average PD for Australian public companies, rising from 5.0% at the end of 2023 to 5.3% at the end of the first half of 2024. Smaller firms have been disproportionately affected, with limited access to capital driving their average PD to 7.4% at the end of the first half of 2024, compared to 1.7% for larger firms.

Currently, corporate credit risk across all Australian public companies is at its highest level since the pandemic. Corporate defaults have also risen sharply across public and private firms, with 11,053 companies entering external administration in FY2024, more than double FY2022 levels and exceeding pandemic-era highs. While expected credit risk diverges based on firm size, with smaller firms facing significantly higher risks, it also varies by sector. Capital intensive, commodity price sensitive and direct consumer-facing sectors show particular vulnerability to credit risks. Corporate defaults have been heavily concentrated in the Construction, Accommodation & Food Services and Retail Trade sectors, accounting for 49% of corporate defaults despite representing only 4% of the corporate universe.

Looking ahead, credit risk is expected to remain elevated throughout 2025 and into 2026. Under Moody's baseline economic scenario, households and firms may see some relief after 2025 as interest rates ease. Credit risk in Australia remains shaped by sector-specific challenges and broader economic pressures. Moody's EDF-X Early Warning System highlights the need for proactive credit risk management, especially in vulnerable sectors, such as Natural Resources, Energy and Utilities. While easing interest rates offer some glimmer of hope, it remains imperative for firms to tailor their risk management practices to their unique sectoral exposures and size. This approach will help businesses navigate current challenges and build financial resilience for the future.

### CONTACT US

AMERICAS  
+1.212.123.4567  
[clientservices@moodys.com](mailto:clientservices@moodys.com)

ASIA (Excluding Japan)  
+852.1234.5678  
[clientservices.asia@moodys.com](mailto:clientservices.asia@moodys.com)

EMEA  
+44.20.1234.5678  
[clientservices.emea@moodys.com](mailto:clientservices.emea@moodys.com)

JAPAN  
+81.1234.5678  
[clientservices.japan@moodys.com](mailto:clientservices.japan@moodys.com)

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