Weekly Credit Brief Apr 17 - Apr 23

China's top property developers face tougher business environment

By Xu Zijun, Lisa

The property sector of China is a prominent part of the Chinese economy as it contributed 6.5% to overall GDP in 2016. Chinese property developers have been aggressively pursuing growth to capture market share by accessing cheap capital to buy land. In 2017, Chinese property developers saw a broad-based improvement in profitability, helped by fast-rising property prices. However, some of China's top property developers still face challenges due to their highly leveraged position in the environment of tightening monetary policies.

To clamp down on leverage in the financial system and further control property prices, China posted restrictions on domestic banks for lending to property companies and made accessing local bond market difficult to highly leveraged developers. According to analysts, bank loans have become more expensive, onshore bond-selling costs have climbed, and trust financing costs have stayed at an elevated 9% to 10% level. Such activities drove major developers offshore to raise debt to fuel their land buying activities. According to data from Bloomberg, Chinese developers raised USD 12.5bn debt in US dollar and Hong Kong dollar this year through February 15, 2018, about a quarter of 2017's total. China Evergrande Group (Evergrande) even issued the highest yield of U.S. dollar bonds, the 8.75% coupon rate notes that due in 2025 yield 8.7%. Furthermore, due to Chinese government's restriction on developers' sales of longer-term offshore bonds, some developers issued bonds with maturities of less than a year that do not require official approval from the National Development and Reform Commission of China. As of April 23, 2018, the two real estate companies that have the highest debt level among the top developers in China, Evergrande and Sunac China Holding Ltd (Sunac), have 48.36% and 39.13% of debt issued in USD respectively.

Meanwhile, rising interest rates also added woe to developers that have piled debts and near maturities as refinancing cost increased. On March 21, the US Federal Reserve raised the key lending rate to the highest level in a decade and on March 22, People's Bank of China (PBOC) raised the key short-term interest rate to crack down the financial risks. The average coupon rate for Chinese local property bonds rose to 6.41% in Q1 2018 from 5.32% a year earlier, according to Bloomberg-compiled data. In the recently concluded Boao Forum for Asia, the governor of PBOC said that the government is ready to accept monetary policy tightening, which added further concerns among developers that financing may be restricted and more costly in the future and consumers may see more stringent criteria to apply for loans from banks.

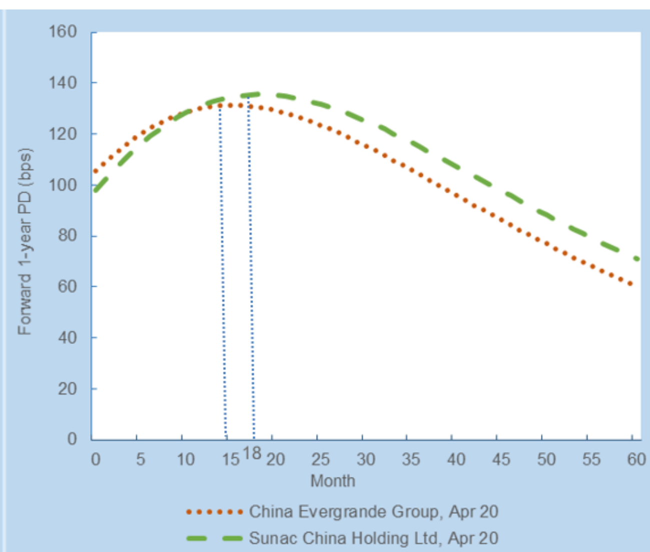

Figure 1 (LHS): RMI-CRI aggregated 1-year PD for top 10 Chinese Developers; Figure 2 (RHS): Forward 1-year PD term structures for China Evergrande Group and Sunac on Apr 20 *Source: RMI-CRI*

Due to the increasing leverage among the top 10 developers and tighter financing regulations that increased borrowing cost, there is a rise in the RMI-CRI aggregate 1-year Probability of Default (PD) for the top 10 Chinese developers, a simple median of the PD for the 10 firms, during the first four months of 2018 (see Figure 1). Figure 2 is the term structure of the RMI-CRI Forward 1-year PD for Evergrande and Sunac. Since Evergrande and Sunac are the two companies that have the highest debt level and leverage ratios among the top 10 developers and about half of their debts are facing maturity before the end of 2020, they have a significantly higher 1-year PD as of April 20. The RMI-CRI 1-year PDs of Evergrande and Sunac on April 20 are represented by the starting point of the curve in Figure 2, month zero. Intuitively, the forward PD computes the credit risk of the firm on a future period, which works like a forward interest rate. For instance, the 3-month forward 1-Year PD is the probability that the firm defaults during the period from 3 months onwards to 1 year plus 3 months, conditional on the firm surviving the next 3 months. Based on the market information available as of Apr 20, 2018, the term structures of the forward PD of Evergrande and Sunac see an increasing trend over the next 15 and 18 months respectively, suggesting that the rising interest rate environment and tighter restrictions from government will continue to affect the performance of these two firms in the following years.

	China Evergrande Group		Sunac Holding Ltd		Median of top 10	
	12/31/2016	12/31/2017	12/31/2016	12/31/2017	12/31/2016	12/31/2017
Net Debt to Total Equity (%)	172.98	237.79	171.92	249.13	55.93	70.34

Table 1: Financial metrics for China Evergrande Group, Sunac Holding Ltd and the median of the top 10 Chinese property developers
Source: Bloomberg

In addition to the increased borrowing cost, the Chinese government is also trying to manipulate the housing sector by introducing policies that induce rising mortgage rates, require higher down-payment and put constraints on buying a second home. In April 2018, the news report that Chinese government is reviving property tax to combat housing bubble, which will add woe for developers to sell their inventories. According to analysts from Moody's, the business environment will be difficult for developers because the tight regulatory measures introduced by the Chinese government, aimed at curbing investment demand and speculation, are likely to remain in place and will limit residential property price and volume growth. All in all, Chinese developers may not have the opportunity to continue to use cheap money to refinance their debt and use these debts to aggressively pursue growth amid tightening credit and other property curbs constraining the market.

Credit News

Scandals, bad debts at India banks threaten economic outlook

Apr 23. Indian banks have had their image tarnished by a string of revealed scandals due to the lack of due diligence. The bad run of scandals, bad debts and cash shortage is starting to have repercussions for the broader economy. India's banking system is handling with USD 210bn of problem loans as the Indian government announced a USD 33bn recapitalization plan in October last year. Some regional banks have also been caught in fraud scandals while the cash crunch has further tarnished the public image of banks. Business sentiment has caused economists to lower India's GDP forecast. Despite these problems, India's banks are still reasonably well capitalized according to international Basel-III capital guidelines. (Bloomberg)

China banks plan informal interest rate increases

Apr 22. Chinese banks met earlier this month to discuss on increases in deposit interest rates as the government continues with its market-based interest rate reforms. The plan was to raise deposit rates to 40-50% above the PBoC's benchmark, from the 30-40% that is currently acceptable. The China central has eliminated the cap on bank deposit rates since 2015 but the authorities have continued to guide lenders to discourage them from raising rates too aggressively. Under the current mechanism, larger banks are restricted to the lower end of bank deposit rates while smaller banks can raise rates to the higher end. The PBoC benchmark currently stands at 1.5% for one-year deposits. The newly appointed governor to the PBoC has reiterated that it would continue with market-based interest rate reforms. (FT)

Gulf companies challenged by debt and rising interest rates

Apr 22. Gulf companies with large financial leverage may be pressured to restructure their debt on the back of rising interest rates. Experts say that the impact of higher interest rates may significantly increase in the next 12 months as the Central Bank of the UAE has raised interest rates four times since the start of the year. Stanford Marine Group, a Dubai oil and gas service company is negotiating to restructure its USD 325mn Islamic loan with banks after it breached loan covenants. Earlier this month, the Gulf General

Investment Company also sought talks with lenders to restructure its loan and credit facilities after the firm defaulted on payment linked to USD 585mn of debt last year. (Arab News)

Fresh twist in race for India's Essar Steel

Apr 20. India's National Company Law Tribunal has recently ordered Essar Steel's creditors to reconsider bids from ArcelorMittal and Numetal, withholding the offer from Vedanta. Both bids from ArcelorMittal and Numetal to acquire the ailing insolvent steel company were previously rejected as ineligible and prompted a second round of bidding in which both companies participated with Vedanta. The court's new movement invoke a possibility that the son of Essar co-founder Ravi Ruia will retain influence over Essar Steel as a quarter of Numetal is owned by an offshore trust whose beneficiary is himself. However, this move will disappoint those who hope that the new insolvency code would force underperforming promoters to walk away from failing companies. (FT)

Wall Street's biggest banks eager to woo consumers with credit

Apr 18. President Donald Trump and the country's top banks are optimistic that the US economy is heading to the greatest boom ever due to an all-time high consumer confidence. The easing of regulations that have been long constraining lending, has prompted Wall Street's biggest banks to shift their focus to woo customers with credit cards, car loans, and other products. While JPMorgan has been expanding its overall consumer book by its Sapphire credit cards, Goldman Sachs is making a consumer push through its online bank Marcus. However, as many banks report lower provisions for future credit losses, concerns are raised on the risk of mounting non-performing loans if interest rate rises amid high household debt. (FT)

GM Korea delays vote on bankruptcy protection to Monday as talks fail (Reuters)

US regulatory rollback boosts sales of debt products (FT)

US banks tap mortgage apps as home lending slows (Business Times)

Regulatory Updates

China is bolstering lenders before new assault on shadow banking

Apr 23. As an effort to prepare Chinese banks for the next phase of deleveraging and financial reforms, the People's Bank of China lowered reserve requirements ratio by 1% last week, freeing up more liquidity for banks. The move will help banks to repay RMB 900bn of outstanding medium-term facility loans they borrowed from the central bank and unleash another RMB 400bn of liquidity which can be used to raise lending. Cutting the reserve ratio came amid the shift away from shadow banking instruments such as wealth management products (WMPs) and will help in relieving systemic risks in the financial system. (Bloomberg)

IMF warns of risks as central banks tighten monetary policy

Apr 19. The IMF urged central banks to adopt a gradual and transparent approach to tightening monetary policy as they believe inflation will remain relatively tame. The IMF added that there are still fragilities in global finance as there is a flood of high-risk bonds and risky asset prices have reached a high point. The report also noted that emerging markets could also be vulnerable to a tightening in financial conditions when there are shocks in inflation. These warnings came as the world moves towards ending the extended period of low interest rates and monetary stimulus after the 2008 financial crisis. (Business Times)

New PBOC chief kicks off reign with 'very clever' reserves move (Business Times)

Saudi central bank to drain liquidity to counter Fed, Libor rise (Bloomberg)

Published weekly by Risk Management Institute, NUS | Disclaimer
Contributing Editor: Liu Hanlei