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NUS-CRI PD demonstrated heightened credit risk for China Huarong Asset Management since early 2018

by Vivane Raj

- **The NUS-CRI 1-year PD indicated an elevated credit risk for China Huarong Asset Management in light of its weak asset quality and increased leverage**
- **China Huarong's international arm faces increased credit strain with weak liquidity and increased refinancing risks**

Chinese credit markets were roiled in Mar 2021 when state-owned China Huarong Asset Management (Huarong) failed to disclose its financial results for 2020, leading to a selloff in its offshore bonds and a suspension in its shares listed on the Hong Kong stock exchange. The country's largest bad-debt manager, Huarong was initially established to manage the non-performing assets of ICBC in 1999. However, the company was thrown into disarray in 2018 when its Chairman, Lai Xiaomin, was arrested for accepting CNY 1.65bn in bribes. Under Lai, the company went beyond its role as a distressed asset manager, aggressively expanding into securities trading and investment management. The company benefitted from such ventures early on, with its main source of revenue in 2017 deriving from its financial investments rather than distressed debt management. At the same time, its net profit increased by 250% from 2013 to 2017, with its total assets ballooning sixfold over the same period. The company liberally tapped into the domestic and offshore capital markets to fund this expansion, taking advantage of low financing costs. However, the company's credit health became progressively strained over the past years as it suffered from excessively high leverage while holding on to loss-making non-core assets. This deterioration in credit quality over the years is demonstrated by the NUS-CRI 1-year Probability of Default (PD) in Figure 1a.

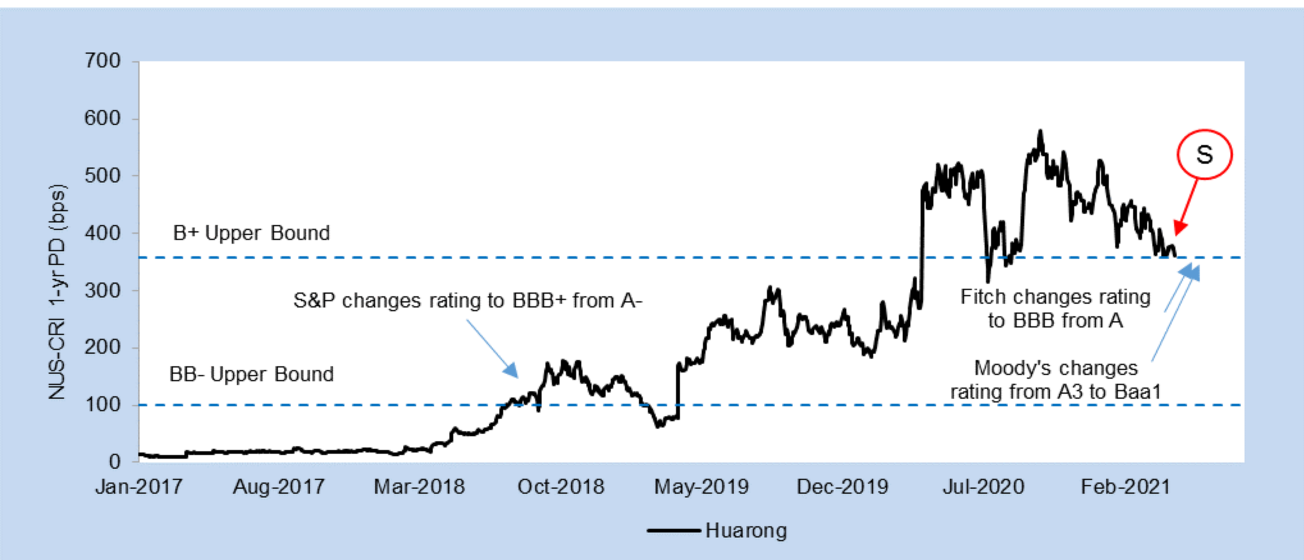

Figure 1: NUS-CRI 1-Year PD for China Huarong Asset Management Company as of Apr 2021 with reference to PDiR2.0[1] bounds; S = Suspension. *Source: NUS-CRI*

[1] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

The PD in Figure 1 shows a rise in the PD for Huarong over the years, which increased steadily since 2018. The PD of the company went above the BB- and B+ upper bounds in Feb 2018 and Mar 2020 respectively. In Aug 2018, major credit rating agency S&P downgraded the company to BBB-rated, while Fitch and Moody's rated Huarong at A and A3 respectively. However, during the recent delayed filings and investor panic, both agencies downgraded the company to BBB and Baa1 in Apr 2021, while major Chinese credit rating agency China Chengxin maintained its AAA rating with a negative outlook. The expectation of strong government support in the case of distress may have factored in Credit Rating Agencies' estimation of stable credit health for the company. At the same time, domestic rating agencies in China could be susceptible to the "ratings cliff" effect, where companies would be more likely to face downgrades only after missing payment obligations. An example of this would be Yongcheng Coal, which was immediately cut from AAA to BB overnight when the company failed to repay principal in Nov 2020.

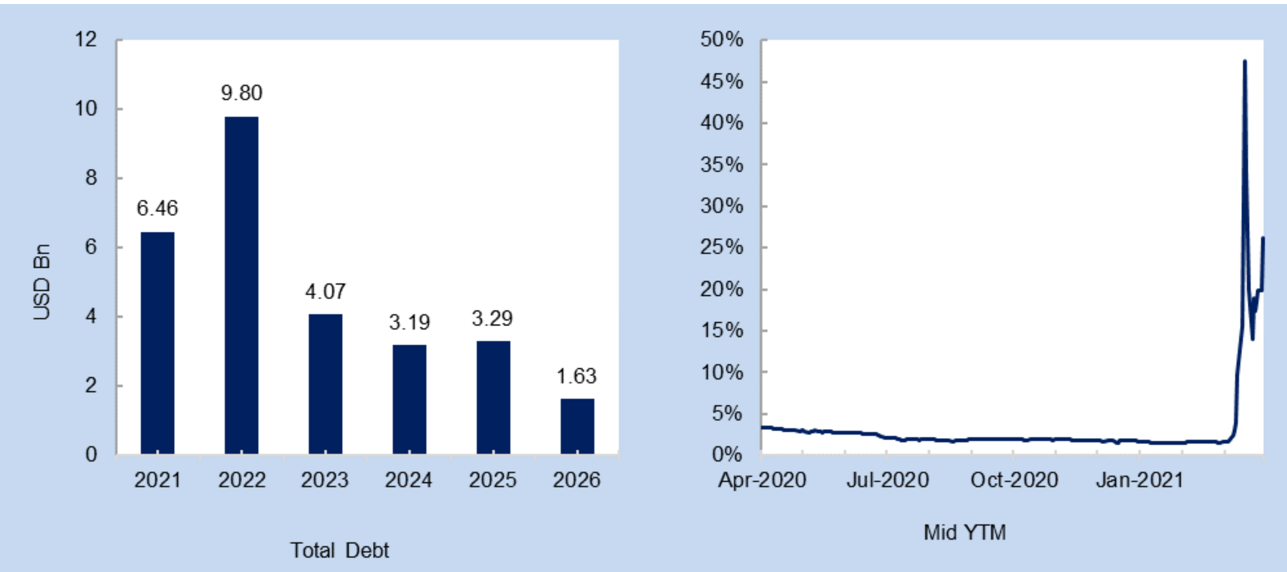

Figure 2a: Breakdown of debt issued by Huarong by maturity in USD. Figure 2b: Mid-yield to maturity for 3¾ USD bond issued by Huarong International maturing on 27 Apr 2022. *Source: Bloomberg*

When inspecting the company on a fundamental level, Huarong's leverage slowly climbed over the years, with its Debt-to-EBITDA reaching 15.91 in the first half of 2020, as compared to 12.70 at the start of 2018 and 7.77 in 2015. The company benefitted from the access to cheap capital early on, as international investors looked to gain exposure to investment-grade debt issuers in China. With easier access to funding, the company was able to expand beyond distressed debt investments. The company provided shadow lending services to borrowers that traditional banks turned away, and involved itself in highly speculative investments into financially distressed companies. The company was invested in HNA Group, which entered bankruptcy restructuring in Jan 2021 and Dandong Port Group, a company that defaulted on bond payments in 2017.

Alongside these failed investments, the company also ventured into highly illiquid financial products over the years under Lai Xiaomin's tenure as Chairman. Over CNY 385bn of assets on Huarong's balance sheet in the first half of 2020 were classified as level 3, meaning that the valuation of these assets could involve unobservable inputs or require external appraisals. The amount of level 3 assets when excluding bad debts stands at CNY 148.5bn, or close to 30% of the total assets held by the company. Included in these assets are items that do not have open or active market quotations, with many of them being highly illiquid. This also had an impact on the profitability of the company, as they had to sustain significant writedowns on the carrying value on these assets, largely attributing to the 95% drop in net income across 2017 to 2019. Attempts to dispose of these assets may be difficult, posing an issue for Huarong if it attempts to bolster its liquidity buffers to manage its upcoming obligations.

The credit health of the company may be placed under additional stress due to its refinancing woes. Investor sentiment on the company's financial health took a beating when Huarong delayed its financial statements in

Mar 2021, which extended into Apr 2021. As seen in Figure 2b, the yield to maturity for an offshore 2022 bond spiked from 1.76% in Jan 2021 to over 47.50% in the middle of Apr 2021, before decreasing to 26.24% at the end of the month. The sharp selloff in bonds and accompanying jump in borrowing costs for Huarong in the international market remains a concern for the company. Overall, this could affect the operational capability of the company going forward, as it uses offshore funding to purchase bad debts from banks. At the same time, yields for Huarong's onshore bonds rose marginally, with yields jumping from 3.01% in the middle of Jan 2021 to 5.07% in Apr 2021. With the company's large appetite for debt, managing its obligations may be a difficult task, with them owing USD 6.46bn by the end of 2021 and a total of USD 16.26bn by the end of 2022 (See Figure 2a). This may be especially troubling as the international bonds maturing this year amount to USD 3.8bn, while the guarantor of these bonds, Huarong International, only holds USD 2.2bn in cash and generate weak cash flows. These offshore bonds are protected by keepwell agreements, which may not guarantee payment to bondholders, leaving international investors in a dangerous position.

Looking ahead, the outlook for Huarong remains uncertain. With the firm potentially undergoing restructuring, offshore bondholders may feel the pinch if Huarong International is spun off and left to fend for itself. The resolution of Huarong's crisis could have ripple effects throughout the Chinese credit markets. If the government were to commit to letting Huarong default, investor perception of Chinese State-Owned Enterprises (SOEs) may nosedive, reducing capital flows and increasing borrowing costs for SOEs in similar situations. In light of the high-profile SOE defaults that shook the Chinese credit market in 2020, authorities may be less willing to provide support to the distressed bad debt manager. However, there may be a light at the end of the tunnel for investors, with the company stating that they will be able to 'make good' on their obligations going forward. As such, it remains to be seen if China Huarong will be able to recover from the trouble that has been plaguing the firm, and if international investors remain confident in the Chinese capital markets in the future.

Credit News

Italian banks may face EUR 9bn in loan losses in 2021-2022

May 1. The Bank of Italy said that Italian banks may face loan losses of EUR 9bn in 2021 and 2022. Although the bad debt ratio of corporate loans is low at 1.5%, the Bank of Italy warned that the rising share of loans that are categorized as "Stage 2" poses a challenge. Stage 2 loans at Italian banks increased by 11% in H2 2020, accounting for 10.7% of all performing loans. The proportion is even higher for loans under moratorium where Stage 2 is 29%, as Italian banks are prompted by regulators to grid for borrowers' possible failure in payments. Italian lenders increased loan loss provisions by a third last year, further hitting profitability, with average ROE dropped to 1.9% in Dec 2020 from 5% one year earlier. Disposals of problem bank loans totaled EUR 33bn euros last year. (Reuters)

Ping An to lead USD 11.3bn restructuring of Peking U's corporate empire

May 1. Ping An Insurance Group and other investors have decided to contribute to a USD 11.3bn bankruptcy restructuring package to secure and rejuvenate a financially troubled corporate empire, Peking University Founder Group (PKU Founder). PKU Founder, a state-owned conglomerate established by China's top university, has been in a bankruptcy proceeding since Feb 2020. On Friday, Ping An and two municipal governments in Guangdong province agreed to lead the restructuring and acquire at least 73% of the new entity, using the proceeds to pay off creditors. The New Founder Group will have four major business segments: health care, finance, information technology and education. Ping An said acquiring a majority stake in the new company would boost its strategic layout in the health care sector and enhance its comprehensive strength and reputation. The deal, however, still needs approval from the regulator and the court. (Nikkei Asia)

Junk-bond boom opens US, Europe to emerging-market borrowers

Apr 28. Companies and governments that were hit by pandemic-induced shutdowns began to turn to the high-yield markets, which have experienced a surge in investor demand. For example, the yields on U.S. CCC-rated bonds have fallen to their lowest levels ever of 5.88%. Many borrowers are looking to take advantage of these falling yields to refinance, with emerging-market issuers borrowing USD 81.2bn YTD in 2021. Investors are willing to take on more risk as the U.S. and European economies rebound, partially helping to support an increase in issuances from developing nations. Some of these borrowers may face difficulty refinancing debt if there is further devaluation in their native currency or a drop in earnings. Such issues may force them to continue refinancing to remain solvent in weak operating environments. (Bloomberg)

India sees record corporate bond defaults amid COVID-19 crisis

Apr 28. India's corporates have defaulted on INR 57bn on local currency bonds in 2021, the highest on record for a similar timeframe. This increase in credit risk has led to yields on A-rated corporate bonds reaching their highest in 17 years, which could pose even worse news for lower-rated small businesses in the country. Disruptions in supply chains have led to increased inflation risk, limiting the central bank's ability to provide economic stimulus. However, the government aims to conduct a quantitative-easing bond buyback program, causing the yield on 10-year sovereign bonds to fall by 12 basis points and a rebound in the rupee. Credit default swaps also rose to a 9-month high before dropping on the news of US medical aid. Issuers face difficulty gaining access to credit markets, with A-rated issuances falling to a 10-year low. (Straits Times)

China bad-debt manager Huarong repays a USD 453mn bond

Apr 27. China's largest distressed-asset manager fully repaid one of its international bonds on Tuesday, trying to soothe investor concerns about its liquidity following a credit-ratings downgrade. The overseas subsidiary of China Huarong Asset Management Co., which helps banks dispose of nonperforming loans, said it redeemed a four-year SGD 600mn bond that matured on Apr 27. It was the first international bond matured since the company's financial statements were delayed raising concerns over its repayment ability. The state-owned company claimed it has not defaulted on any international bonds. Furthermore, it stated that the operating condition of its overseas subsidiary has gradually improved and it has normal liquidity. Partly thanks to its improvement in risk management and internal controls, it has also reversed the losses incurred since 2018 and was profitable in Q1 2021. (WSJ)

Singapore Airlines raises USD 1.5bn from airplane sale and leaseback deals (Reuters)

Investors urge Brazil to use green bonds to save the Amazon (FT)

Ares raises USD 11bn private debt fund amid alternative lending rush (Reuters)

Regulatory Updates

ECB's Weidmann says government finances mustn't delay tightening

May 1. European Central Bank (ECB) policymaker Jens Weidmann said they must be prepared to tighten monetary policy when necessary to curb inflation, even if that puts pressure on highly indebted governments. As institution risks getting deeply involved with fiscal policy for large-scale bond purchases, which were stepped up during the pandemic, Weidmann was worried that fiscal policy would increasingly smother monetary policy. Recently, the ECB increased its pace in bond-buying through a pandemic purchase program of EUR 1.85tn to prevent high borrowing costs. Weidmann was concerned that this could weaken market discipline, while other central bankers held that they would not be under pressure to keep monetary policy loose ignoring accelerating inflation. As price pressures rise, the debate is gaining ground. The ECB has stated that any inflation jumps will be transient, and Weidmann said he doesn't currently expect the increase in money supply resulting in persistently elevated price increases. (Bloomberg)

German government proposes green funding tool to help industry cut CO2

Apr 30. Germany's government proposed plans for contracts for difference (CfDs), tools that help companies in steel, cement and ammonia industries finance the transition to low-carbon technologies. According to a draft plan, companies that commit to slashing CO2 emissions by more than half through innovative technologies could be granted permission to operate based on 10-year CfDs. This plan outlines a strategy for CfDs payments, which require companies to bid in auctions and guarantee a minimum strike price for low-carbon products. The mechanism reduces its operating cost and the uncertainty over the emissions permit prices and thus helping planning and access to finance. Germany hopes to develop green hydrogen derived from wind and solar renewables to produce synthetic fuel for the industry, energy and transport sectors. The draft plan is subjected to state aid scrutiny by the EU. (Reuters)

Nigeria hikes capital requirement for pension managers as mergers loom (Reuters)

Shanghai bourse strengthens corporate bond disclosure (Reuters)

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Contributing Editors: Yao Xuan, Anthony Prayugo, Raghav Mathur