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Regulatory support and industry consolidation might provide tailwinds to the distressed Chinese developers

by Wang Chenye

- **NUS-CRI Agg PD shows that, despite supportive policies, the Chinese real estate market downturn continues to erode the credit quality of the developers, exhibiting a higher divergence in the credit quality of the top and bottom quartile of companies**
- **NUS-CRI Forward PD suggests that the credit profile of the industry might improve given the continued regulatory support and active horizontal industry consolidation indicated by the rising NUS-CRI Forward POE**

The real estate market in China experienced a brief rebound at the beginning of 2023 followed by a plunge in home sales in June with MoM declines in both housing prices and transaction amount. Although since the end of 2022, favorable real estate policies ("Three arrows") have frequently been released by regulators, the damage dealt by the "Three red lines" property rules has not dissipated. Market confidence for Chinese real estate remains low and housing demand continues to be depressed. The NUS-CRI 1-year Aggregate (median) Probability of Default (Agg PD) for the Chinese real estate companies gradually climbed up by over 50 bps during the first half of 2023, with the interquartile spread of the PD greatly widened to 400 bps, mainly due to the surging Agg PD for the most vulnerable companies (75th percentile). In contrast, companies in the first quartile saw their Agg PD remain relatively stable, mildly fluctuating around 100 bps. The widening gap suggests the polarized industry differentiation as the top performers have more access to capital market financing. The ongoing horizontal industry consolidation mainly initiated by the state-owned developers might contribute to the restoration of the credit health of the real estate market. Given the industries' significance to the wider economy, further supportive policies are expected to ease the credit conditions for the surviving developers, as suggested by the decreasing NUS-CRI Aggregate (median) Forward 1-year PD (Forward PD[1]) shown in Figure 1b.

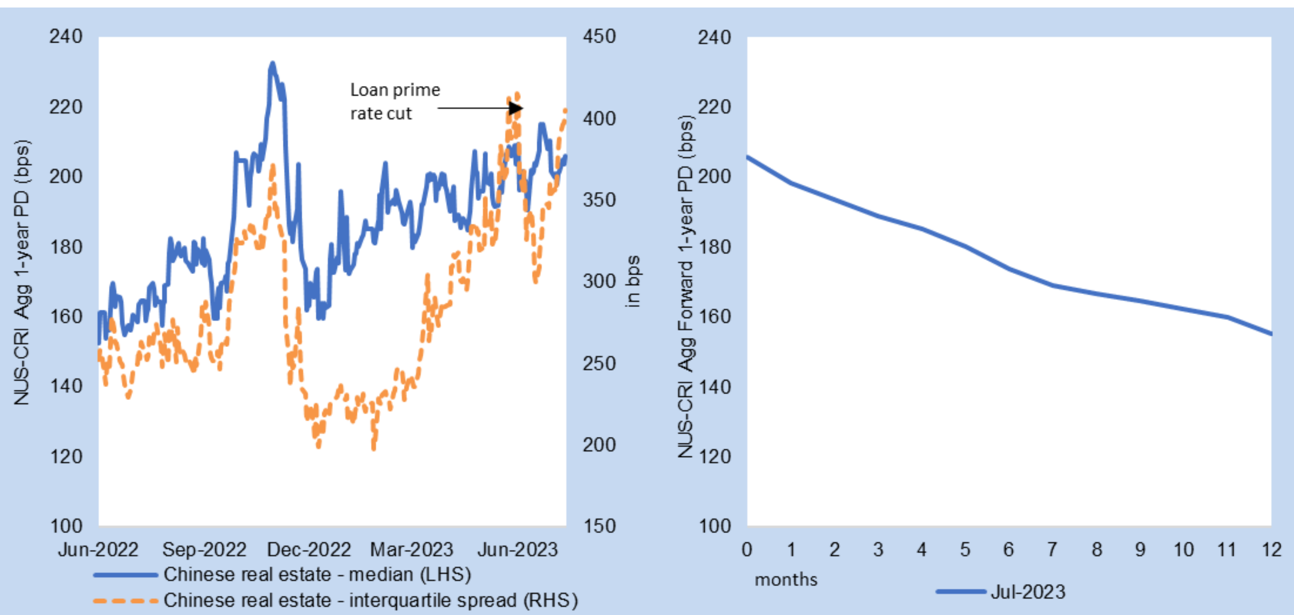

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Chinese real estate companies and the industry's Agg PD's interquartile spread.
Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Chinese real estate companies as of Jul-2023. *Source: NUS-CRI*

[1] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months, conditional on the firm's survival in the next 6 months.

The debt servicing pressure for Chinese developers has remained persistent. For companies in our sample, the defaulted debt amount has reached USD 23bn since the start of the real estate market downturn (see Figure 2a), mainly due to the imposed deleveraging by the "Three red lines" property rules, which exposed the indebted financial nature of the industry[2] and greatly constrained their refinancing ability. Though there are signs of easing, with over USD 15bn (11.6% of the total debt outstanding) maturing within this year, the real estate companies are still under significant debt payment pressure (see Figure 2a). In the next two years, 47% of maturing debt is denominated in USD and HKD, and as the interest rate gap between China and the US widens, companies that issue these foreign currency-denominated debts will not only face higher financing and servicing costs but also higher foreign exchange costs should the Chinese yuan continue to depreciate. Though there have been supportive policies to help real estate companies access the necessary financing since Nov-2022, both domestic and international capital markets are still cautious about investing and lending to the industry. Thus, while financing may be more accessible to the top performers in the industry, the more vulnerable firms may still struggle to raise capital. The total amount of non-bank financing obtained by real estate companies in the first half of 2023 declined by 16.2% YoY. While the top performers in the industry issue uncovered bonds and asset-backed securities (ABS), the weaker performers might not be able to access diversified credit channels and still predominantly relied on bank financing, making them more susceptible and responsive to the loan cost change. After the PBOC's recent loan prime rate cut in Jun-2023, the PD for the vulnerable companies dropped, yet bounced back quickly in July, which may indicate that the positive effect of the rate cut is unsustainable due to the strong demand headwinds.

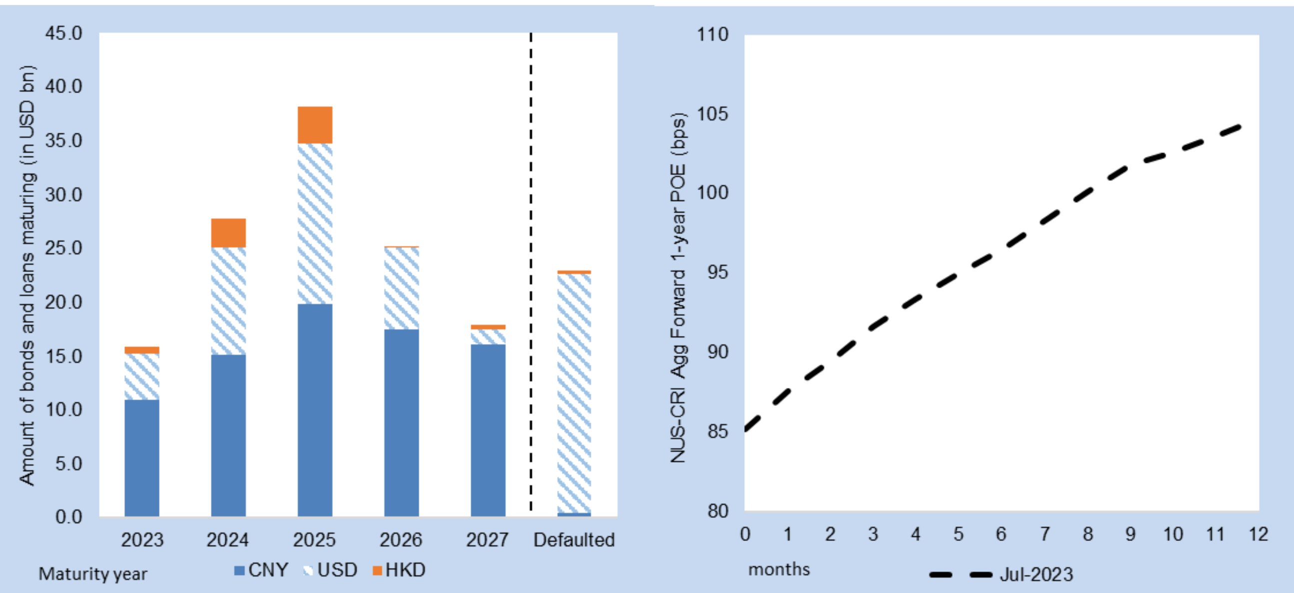

Figure 2a (LHS): Total amount of debt defaulted since Jul-2021 and the total amount of debt maturing for the Chinese real estate companies as of July 17th, 2023. Figure 2b (RHS): NUS-CRI Agg (median) 1-year Forward Probability of Other Exits (POE)[3] for the Chinese real estate companies as of Jul-2023. *Source: Bloomberg; NUS-CRI*

With numerous unfinished construction projects, the real estate companies are in need of stable cash inflows, which have been dampened due to a drop in demand as market confidence for homebuyers wavers, to cover their working capital requirements. New home prices in hundreds of cities in China have fallen for consecutive months, and the secondary housing market is oversupplied. It is expected that the demand in the real estate market will remain weak in the near future. The sluggish real estate market also negatively impacts the land market. The dimmed real estate prospects hurt the ability and willingness of the developers bidding for land-use rights. As one of the most important revenue resources for local governments, the land-use right sale revenue has been shrinking along with the property market downturn, making it difficult for some of the local governments to meet their debt obligations or fiscal expenditures[4]. Consequently, with less government investment in the economy, there have been signs of deflation despite the continuous credit-easing policies from the PBOC. Deflation will lead to a decline in the vitality of the entire economy and slow down the growth rate, which is more unfavorable to the recovery of the property market.

[2] On July 17th, 2023, the newly published annual report as of Dec-2022 of China Evergrande Group shows that there are short-term borrowings of CNY 587bn and long-term borrowings of CNY 25bn on its consolidated balance sheet given a yearly loss of CNY 126bn.

[3] The Forward POE estimates the probability of other exits of a company in a future period, similar to the concept of Forward PD. Delisting due to other reasons such as failure to meet listing requirements, inactive stock prices or mergers and acquisitions are counted as "other exits" and are not considered as default.

[4] Guizhou is one such Chinese province which is currently struggling under the weight of its debt obligations even as scores of infrastructure projects in the province remain incomplete.

The real estate industry used to be a pillar of China's economy, accounting for around 20% of the Chinese GDP. Therefore, maintaining a stable and healthy real estate market is crucial to China's economic development. Since last year, the state-owned real estate companies, benefiting from easier access to capital market financing and more favorable bank loan terms, started to selectively acquire the non-state-owned real estate companies or assets, helping the distressed non-SoEs avoid further defaults or bankruptcies. Right after the regulators unblocked the equity financing channel for the real estate industry by the end of 2022, at least 48 mergers and acquisitions were initiated in the industry with a transaction amount of over CNY 52.8bn in Dec-2023, a significant increase of 72.4% from the previous month. Furthermore, the NUS-CRI 1-year Forward Probability of Other Exits (POE) increases over the next 12 months (see Figure 2b), suggesting the consolidation activities in the market might continue, as delisting pressure faced by the underperforming companies mounts. With default pressures mounting, indicated by the Agg PD for the most vulnerable companies (those in the upper quartile) rising, and with further consolidation of state-owned developers picking up pace in the industry, developers that are likely to survive the current downturn are likely to benefit from an improved credit profile, suggested by the downward-sloping Forward PD in Figure 1b.

Credit News

US junk bond market shrinks as rising rates put off borrowers

Jul 12. The US junk bond market has shrunk by almost USD 200bn since its peak in late 2021, raising concerns about misleading signals regarding the US economy. Rising interest rates and companies moving to investment-grade territory have discouraged bond issuances, especially as market participants move towards private credit. Investors have fewer options, leading some fund managers to buy bonds they might not have chosen otherwise, supporting prices for junk bonds. However, this situation risks overvaluation and a sharp price decline if economic conditions worsen as market volatility increases under the risk of a recession. The shrinking market and the rise of private credit as an alternative financing option are also providing some headwinds for companies looking to issue new bonds. Rating upgrades have also buoyed the market, with only USD 15.6bn of debt downgraded to junk as of Jun-2023, compared to USD 116bn throughout 2022. (FT)

China's murky debt corner faces funding squeeze

Jul 15. The USD 9tn of Chinese local government bonds, which played a crucial role in boosting the global economy after the 2008 financial crisis, now pose a growing risk. China's state-run investor has advised asset managers to sell some of the local municipal debt, adding pressure on the securities. Managing the situation has become a careful task for authorities, as they aim to mitigate risks to lenders without triggering defaults or increasing systemic risk in the country's domestic financial system. Any collapse in bonds from local government financing vehicles would have a ripple effect on the local banking system and hinder overall growth in China. The potential impact is substantial, with approximately CNY 34tn (USD 4.75tn) of local government debt held by banks. The rising levels of municipal borrowing have become a top financial risk. Furthermore, many local government financing vehicles have faced challenges in accessing financing options, leading to higher borrowing costs and reduced investor interest. (Bloomberg)

Indonesia, South Korea bonds benefit from China turmoil

Jul 17. Global investors are increasing their holdings in Asian bonds outside of China, with a focus on countries like Indonesia and South Korea that are expected to see currency appreciation amid potential weakness in the US dollar. Inflows into emerging Asian bond markets, excluding China, reached USD 20.2bn in the first half of 2023, the highest in the past two years. South Korean and Indonesian bonds have been favored by overseas investors, while China experienced an outflow of USD 29.6bn in the same period. Investors are betting on the end of the US dollar's strength as the Federal Reserve nears the end of its rate-hiking cycle. Concerns about the yuan, uncertainty about economic stimulus measures in China, and geopolitical tensions have made investors cautious about Chinese bonds. As a result, many fund managers have reduced their exposure to Chinese fixed-income investments, while parking their liquid capital in other emerging markets in Asia. (Nikkei Asia)

Real estate is most distressed sector in Europe, study finds

Jul 13. The real estate sector in Europe faced significant distress in the second quarter of the year due to various factors. Liquidity pressure, declining investment metrics, and reduced profitability were the main drivers. Rising interest rates, increased debt servicing costs, and a decline in demand for office spaces have created intense market pressure. The Weil European Distress Index report, which analyzes data from over 3,750 listed European firms, highlights the distress in the real estate sector. (Bloomberg)

Bank of Canada's record tightening campaign exposes lenders' mortgage risks

Jul 14. The Bank of Canada's interest rate hike and the possibility of further increases pose risks to mortgage lenders and homeowners. Rising borrowing costs may lead to difficulties in making higher payments or covering interest portions of loans. Stricter capital rules have been proposed by Canada's banking regulator to prevent defaults and negative amortization. Renewing mortgages every five years at prevailing rates sets Canadian borrowers apart from the US. The central bank's projection for inflation reaching its target has been delayed, indicating prolonged higher interest rates. With approximately USD 583bn in mortgages coming up for renewal in 2024 and 2025, refinancing poses a significant challenge. Despite strong employment and stress tests, potential risks remain. (Reuters)

Vedanta bonds fall as liquidity worries revive amid chip setback (Bloomberg)

Global public debt hits record USD 92tn, UN report says (Reuters)

Thames Water crisis fragments industry's USD 60bn bond market (Bloomberg)

Regulatory Updates

China's central bank signals more policy support for economy

Jul 13. The People's Bank of China (PBOC) has indicated that it is ready to provide more policy support for the economy while urging patience for the recovery process. PBOC officials stated that they have enough room to ease monetary policy if necessary, including possible adjustments to the reserve requirement ratio for banks and targeted easing of property controls. The PBOC plans to implement targeted and forceful monetary policies, adjust money supply, lower financing costs, and provide support to small firms, green sectors, and innovation. While facing challenges such as potential deflation, sluggish economic growth, and a weakening property market, the PBOC did not signal immediate cuts to policy rates. (Bloomberg)

US Fed official calls for increase to bank capital requirements

Jul 11. A senior Federal Reserve official, Michael Barr, has put forth proposals to raise capital requirements for large and mid-sized US banks as part of a comprehensive plan to strengthen banking regulation and supervision. The proposals aim to enhance oversight of banks with over USD 100bn in total assets, including mid-sized institutions that faced financial stress earlier this year. The plan would subject more banks to the Fed's risk-sensitive capital rules, currently applicable only to internationally active firms or those with USD 700bn or more in assets. However, the proposals have received mixed reactions, with the president of the American Bankers Association expressing concern over potential negative consequences for the banking sector. (CNA)

S Korea central bank warns of financial stability risk as debts rise (CNA)

Hawkish ECB said more rate rises may be necessary, minutes show (FT)

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