Credit Research Initiative
National University of Singapore
transforming big data into smart data
NUS National University of Singapore
AI·DF Asian Institute of Digital Finance
Weekly Credit Brief Jul 25 - Jul 31 2023

Credit profiles of Chinese and EU automakers diverge amidst demand and financing headwinds

by Raghav Mathur

- **NUS-CRI Agg PD shows diverging credit trends for the Chinese and EU automakers, with the former improving in tandem with the global median, while the latter remains relatively stable**
- **NUS-CRI Forward PD suggests that the credit risk outlook for the EU auto industry deteriorates in the short term driven by financing and profitability headwinds**

The credit profile of the global automotive industry stands out as robust compared to other industries that have been suffering from high interest rates and have been dragged down by recessionary expectations, as they pivot their production strategies towards autonomous and electric vehicles. The NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) of the global auto industry has improved since the beginning of the year, with the Agg PD improving into the investment grade threshold of BBB- upper bound when referenced to PDiR2.0 bounds[1] (see Figure 1a). However, the global recovery in automotive credit risk profiles is divergent among geographies. As seen in Figure 1a, the Agg PD of the European Union's auto industry does not benefit from the recovery seen by its global peers, whereas the China-domiciled auto industry sees a substantial improvement in its aggregate credit risk profile. Furthermore, the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[2]) for the global auto industry suggests that headwinds are present over the next 24 months, highlighting the medium-term financing and profitability challenges that are present for the industry. The Forward PD term structure's trend suggests that credit risk is likely to increase over the next year, especially for the EU-domiciled automakers, after which their credit risk might stabilize at elevated levels, conditional on entities surviving the pressure of their worsening credit profiles.

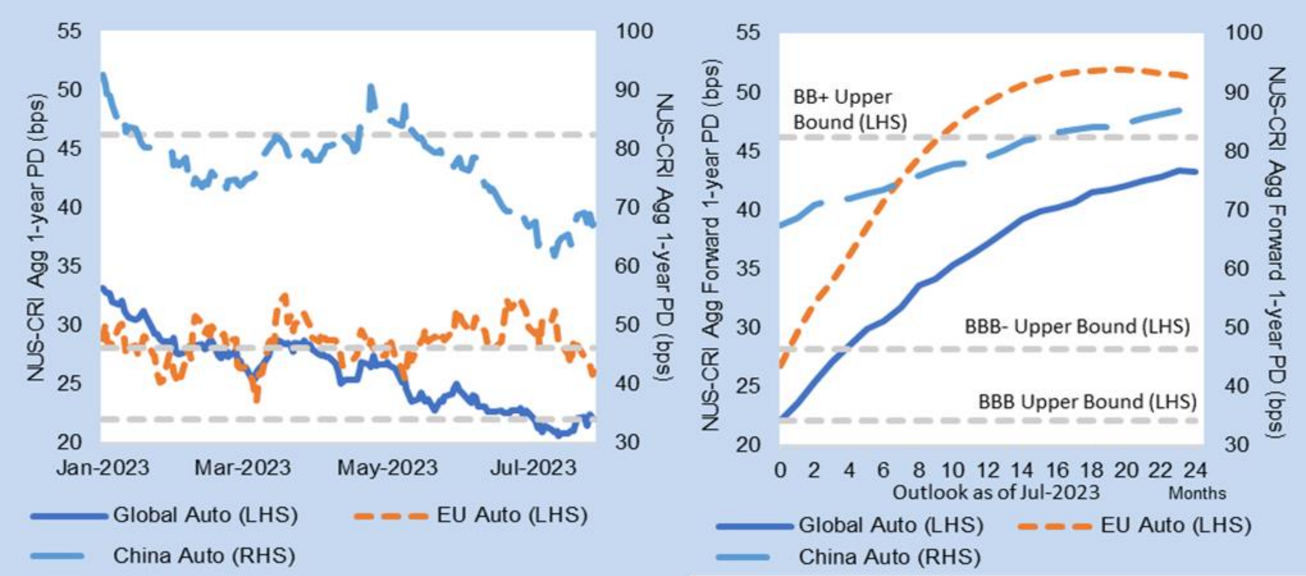

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for the Chinese (RHS axis), EU (LHS axis) and global auto industry (LHS axis), with reference to PDiR2.0 bounds (LHS axis). Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for the Chinese (RHS axis), EU (LHS axis) and global auto industry (LHS axis) as of Jul-2023, with reference to PDiR2.0 bounds (LHS axis). *Source: NUS-CRI*

[1] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation by 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.

[2] 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 competitive landscape within the industry is changing as Chinese domestic demand weakens and as Chinese automakers ramp up exports. The demand downturn in China's domestic market amidst the country's current economic slowdown has diminished the position of global automakers that wanted to capitalize on a rebound after China's re-opening at the end of last year. Foreign automakers have long held the dominant market share of the Chinese market, however, in the first half of 2023, domestic players, especially those that specialize in EVs (such as BYD, Nio, Li Auto, and Xpeng), took over the dominant market position in China, amassing close to 53% of the domestic market by Jun-2023. The increase in the market share for Chinese automakers saw the CSI All Share Automobiles Index increase by almost 15% YTD to CNY 9102.21.[3] Domestic automakers' credit profiles also benefited due to increased revenue from their exports. Total exports of Chinese vehicles, primarily driven by electric vehicles, increased 76% in H1 2023 to 2.14mn units, overtaking Japan as the largest auto exporter in the world. Resultantly, in accordance with, and contributing to, the improvement in the credit risk profile of the global median, the China-domiciled auto industry has seen a decrease in their Agg PD from a peak of close to 93bps at the start of 2023 to 68bps as seen in Figure 1a.

However, the boom in China's automotive industry and its leading position as a global exporter have put pressure on the top and bottom line of automakers domiciled in the EU. For example, Volkswagen, which has long held the top spot in vehicle sales in China and for which close to 20% of global revenue originated in the Chinese market, is likely to face the pressures of lagging sales impact its profitability moving forward. Demand pressures and strong global competition are also likely to hamper demand for European autos closer to home. Though sales of Chinese EVs are still a small proportion of all vehicles sold in the EU, forecasts suggest that they could contribute to sales of up to 1.5mn units by 2030, which would be equivalent to 13.5% of all vehicle sales in the EU last year. In addition, European automakers are also tapping into the bond market to raise additional financing, despite facing higher refinancing costs. As seen in Figure 2a, bond issuances by EU-domiciled auto companies reached a six-year high of EUR 8.4bn in May-2023 with the average yield to maturity, based on Bloomberg EuroAggregate Automotive TR index, of 4.15%, an increase in servicing cost of almost 200bps since the start of last year. Though a significant proportion of new debt issues is likely to be appropriated for in-house vehicle financing, EU households that are already bearing the brunt of high inflation are unlikely to purchase new vehicles, and thus the increased credit availability may not translate directly to an increase in sales. As suggested by the Forward PD in Figure 1b, combined headwinds of higher financing and servicing cost, in conjunction with lower revenue-generating capabilities, are likely to worsen the credit risk profile of the EU's auto industry.

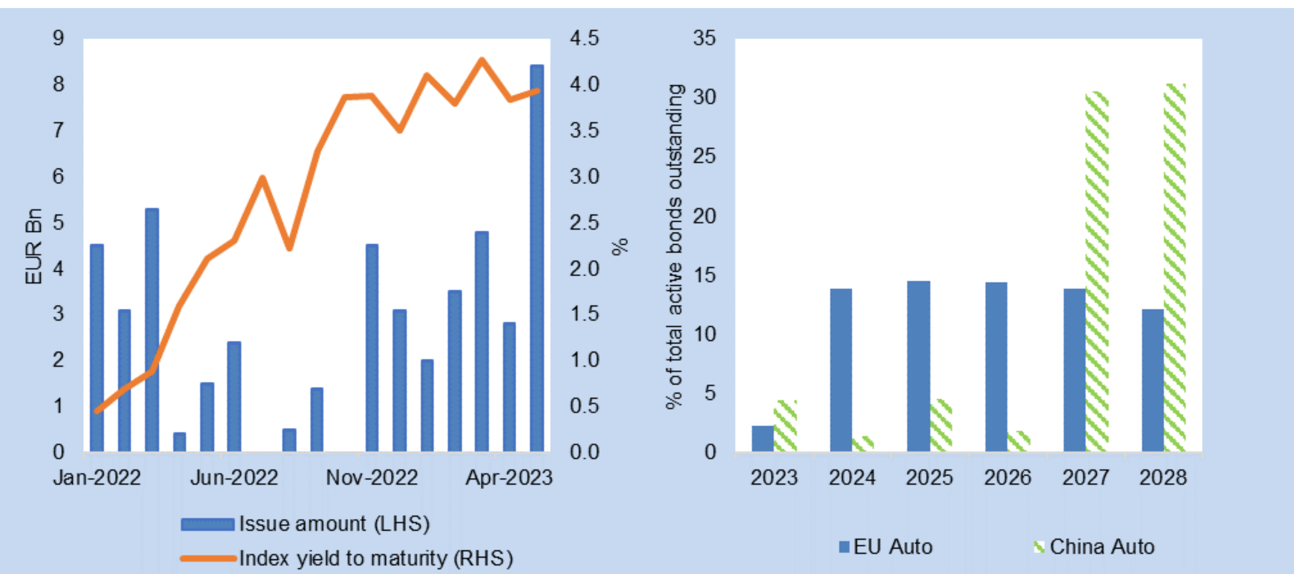

Figure 2a (LHS): Total debt issuances (in EUR bn) by EU-domiciled companies and the index yield to maturity of the Bloomberg EuroAggregate Automotive TR index. Figure 2b (RHS): Proportion (%) of total debt outstanding for the automotive industry in the EU and China. *Source: Bloomberg*

Furthermore, many EU automakers' financing units have started relying more heavily on their retail deposits as a way to finance in-house lending for vehicles. Acting as 'pseudo' banks, the EU auto industry's financing arms have raised the interest they provide on savers' funds to attract more deposits, seeing them as a cheaper financing channel than tapping traditional bond markets. Though this strategy has provided EU-domiciled automakers with much-needed access to cheap financing, should automakers transition to continue relying on deposits for funding, they are likely to be heavily regulated and may thus have to incur additional costs that may

[3] Data from Bloomberg.

hamper their financial performance. However, access to alternative financing channels becomes increasingly important for the EU auto industry given the increasing debt servicing burden they face in the near future amidst waning demand prospects. EU autos' debt maturity schedule is heavily front-loaded compared to their Chinese counterparts, with close to 30% of their outstanding debt due over the next two years (see Figure 2b). As such, should the EU auto industry struggle to increase its free cash flows, its credit risk is likely to increase, possibly in line with the worsening outlook suggested by the Forward PD in Figure 1b.

In effect, to improve the competitive position of EU automakers in the global landscape, European governments are likely to impose protectionist policies, similar to the ones seen in the US. For example, the French finance ministry has already changed the criteria for which producers are eligible for subsidies given their net carbon emissions. Though this is an industry-wide policy, it is especially going to harm Chinese EV producers that heavily rely on coal for electricity generation. Given these geopolitical tensions and the resultant protectionist policy that is likely to continue curbing import demand amidst an overall demand slowdown, it is likely that the market witnesses Chinese automakers and part manufacturers entering the EU market through joint ventures. For example, China's XTC New Energy Materials recently announced a joint venture with French nuclear group Orano to produce battery components. European carmakers, in the face of China's domestic demand headwinds, are also increasing their exposure to the Chinese market by buying a stake in domestic manufacturers. For example, Volkswagen recently announced a USD 700mn investment in XPeng for a 5% stake. As such, despite the diverging trends in the credit profiles of EU and Chinese automakers, industry consolidation across borders through JVs and investments are likely to provide some tailwinds, especially to the EU auto industry that sees its Forward PD stabilize after 20 months (see Figure 1b). However, in the short term, protectionist policies and waning demand globally are likely to pose challenges for the auto industry as suggested by the worsening term structure of the Forward PD for global autos in Figure 1b.

Credit News

China debt ratio hits record but pace of borrowing is easing

Jul 26. China's debt-to-GDP ratio reached a record high in the second quarter, standing at 281.5% according to calculations based on data from China's central bank and the National Bureau of Statistics. Although consumers and businesses are borrowing at a slow pace, indicating low economic confidence, the situation doesn't seem to fit the typical "balance sheet recession" scenario with reduced corporate and household leverage directly impacting the economy. Nevertheless, economists suggest that slower borrowing growth will exert pressure on GDP growth, leading to a somewhat similar outcome. (Bloomberg)

EU stress test shows three banks falling short

Jul 29. According to the European Banking Authority (EBA), three banks from the European Union failed to meet mandatory capital requirements in a recent stress test, resulting in a theoretical loss of EUR 496bn (USD 546bn) from their buffers. The test covered 70 banks, including 57 eurozone banks overseen by the European Central Bank. German lenders drew attention, with eight out of 14 tested falling below the EU average for CET1 and leverage ratio. While the EBA highlighted the overall resilience of the EU banking sector, concerns lingered as some banks faced challenges in meeting their mandatory capital requirements. (Reuters)

Booming markets neutralise impact of rate rises on US corporate fundraising

Jul 28. Rising stock prices and falling bond yields have made it easier for US companies to raise funds, neutralizing some of the impact of Federal Reserve interest rate hikes. The National Financial Conditions Index, compiled by the Chicago Fed, has reached its lowest point in 16 months, indicating looser financial conditions. However, this runs counter to the Fed's goal of slowing the economy to control inflation and may result in higher interest rates being maintained for a longer period. The easing of financial conditions reflects investor confidence that the Fed has concluded its interest rate hikes due to decreasing inflation. Still, concerns about tightening lending standards remain. (FT)

Commercial real estate investors risk painful losses in post-COVID world

Jul 31. Commercial real estate investors and lenders are facing uncertainty as remote work and online shopping trends challenge the demand for traditional office spaces and malls. Major cities like London, Los Angeles, and New York may experience prolonged recovery periods for their real estate markets. Rising interest rates and inflation further add to the concerns. Global banks are holding a substantial amount of commercial real estate debt, with a significant portion maturing in the coming years. While some experts warn of potential defaults and liquidity problems, others believe a 2008-style credit crisis is unlikely. However, the industry is adapting to the changing landscape with some businesses reducing their office space and focusing on sustainability. Overall, property returns are expected to be lower in the coming years compared to pre-pandemic levels. (Reuters)

Bank of Japan monetary policy tweak sends bond yields to 9-year high

Jul 28. The Bank of Japan made an unexpected move by easing controls on its government bond market, a crucial element of its ultra-loose monetary policy. The BoJ announced that it would buy 10-year Japanese government bonds at a fixed rate of 1%, effectively widening the trading band on long-term yields. Although the central bank maintained its previous 0.5% cap on 10-year bond yields, it described this level as a reference rather than a strict limit. The 10-year Japanese government bond yield surged to its highest level in almost nine years, reaching 0.572% following the BoJ announcement. The benchmark Topix stock index initially fell 0.2%, while the banking sub-index rose 4.5%. BoJ Governor Kazuo Ueda clarified that the central bank was not ready to allow yields to move freely, signaling its commitment to yield curve control and maintaining its longstanding bond-buying policy**.** (FT)

Wanda Group sells USD 310mn stake in investment unit to repay debt (Nikkei)

Swedish household lending growth hits all-time low on rates (BT)

Adani tests demand for financings that may top USD 1bn (Bloomberg)

Regulatory Updates

ECB raises interest rates back to record high

Jul 27. The European Central Bank (ECB) has raised its interest rates to a record high of 3.75 % but has also signaled that borrowing costs in the Eurozone may have reached their peak. This decision marks the ninth consecutive rate rise by the ECB, matching a level last seen in 2001 when it aimed to strengthen the newly launched euro. However, investors are increasingly speculating that these rate increases could be the last, as inflation is falling faster than anticipated in both the eurozone and the United States. (FT)

Regulators announce 'Basel III endgame' rules for large US banks

Jul 28. US bank regulators are moving forward with plans to impose stricter capital requirements on large US lenders, potentially leading to the allocation of billions of additional dollars collectively for potential losses. The proposed rules target banks with assets exceeding USD 100bn. The implementation timeline grants banks until the beginning of 2028 to comply fully, allowing for a smooth adjustment with minimal adverse effects. The regulations seek to establish a uniform industry standard for measuring lending and other risks, diverging from banks' prior practices of self-assessment. As a result, institutions will be compelled to hold more capital to absorb potential losses. Smaller banks will be exempt, while larger regional lenders will now face stricter capital requirements to mitigate financial distress. (FT)

China appoints Pan Gongshen as new central bank governor (Nikkei)

RBA watchers split as policy tightening cycle is nearing end (Bloomberg)

Published weekly by Credit Research Initiative – NUS | Disclaimer
Contributing Editors: Amrita Parab, Wang Chenye, Claudio Bonvino